Bankruptcies and liquidations

Partially updated March 2023
About the Bankruptcies and liquidations guide

PwC is pleased to offer our Bankruptcies and liquidations guide. This guide furthers our aim of helping our clients and other interested parties to implement the accounting and reporting standards applicable to bankruptcies and liquidations.

While the accounting guidance for bankruptcy accounting has not been updated for a number of years and is unique, it remains relevant given the continued volume of bankruptcy filings. This guide explains the fundamental principles of bankruptcy and liquidation-basis accounting, as well as considerations prior to entering bankruptcy, for companies that prepare financial statements under US GAAP, and provides our perspectives on the application of those principles.

This guide summarizes the applicable accounting literature, including relevant references to and excerpts from the FASB’s Accounting Standards Codification (the Codification). It also provides our insights and perspectives, interpretative and application guidance, illustrative examples, and discussion on emerging practice issues. The PwC guides should be read in conjunction with the applicable authoritative accounting literature.

References to US GAAP

Definitions, full paragraphs, and excerpts from the FASB’s Accounting Standards Codification are clearly labelled. In some instances, guidance was cited with minor editorial modification to flow in the context of the PwC Guide. The remaining text is PwC’s original content.

References to other PwC guidance

This guide focuses on bankruptcy and liquidation-basis accounting and financial reporting considerations. It supplements information provided by the authoritative accounting literature and other PwC guidance. This guide provides general and specific references to chapters in other PwC guides to assist users in finding other relevant information. References to other guides are indicated by the applicable guide abbreviation followed by the specific section number. The other PwC guides referred to in this guide, including their abbreviations, are:

- Business combinations and noncontrolling interests (BCG)
- Consolidation (CG)
- Derivatives and hedging (DH)
- Equity method investments and joint ventures (EM)
- Fair value measurements (FV)
- Financial statement presentation (FSP)
- Financing transactions (FG)
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- Foreign currency (FX)
- Income taxes (TX)
- Inventory (IV)
- Leases (LG)
- Loans and investments (LI)
- Property, plant, equipment and other assets (PPE)
- Revenue from contracts with customers (RR)
- Stock-based compensation (SC)

**Summary of significant changes**

Following is a summary of recent noteworthy revisions to the guide. Additional updates may be made to future versions to keep pace with significant developments.

**Revisions made in February 2023**

**BLG 3, Accounting and reporting during bankruptcy**

- **BLG 3.3** and **Figure BLG 3-3** were enhanced to clarify the discussion of liabilities subject to compromise.

- **Question BLG 3-5** was edited to clarify the discussion of when unsecured and undersecured liabilities may be reclassified from liabilities subject to compromise.

- **Figure BLG 3-5** was updated to clarify the sample income statement under ASC 852-10.

- **BLG 3.10.1** was updated to clarify considerations related to accounting for reorganization items during bankruptcy.

- **BLG 3.16** was enhanced to add guidance from ASC 718-20-35 for accounting for stock-based compensation during bankruptcy.

- **BLG 3.18** was updated to remove discussion of rare scenarios in which a solvent parent continues to consolidate a subsidiary in bankruptcy given its limited applicability in practice.

**BLG 4, Emerging from bankruptcy**

- Content in **Question BLG 4.3** was moved to **BLG 4.4.5**.
Revisions made in October 2022

BLG 1, An introduction to bankruptcy proceedings

- BLG 1.2 was updated to discuss the enactment of the Bankruptcy Threshold Adjustment and Technical Corrections Act.

BLG 2, Accounting and reporting considerations prior to entering bankruptcy

- Certain sections of BLG 2 were reordered.
- BLG 2.2.5 replaced the discussion of leases under ASC 842 and ASC 840 that was previously included in BLG 2.3.2 and BLG 2.3.2A, respectively.
- BLG 2.2.7 (formerly BLG 2.2.8) was updated to include discussion of a reporting entity’s consideration of a customer’s credit risk as it relates to measuring impairment losses for accounts receivable and contract assets in accordance with ASC 310 or ASC 326, once adopted.
- BLG 2.3 was reorganized to only include discussion of employee-related matters. The content formerly in Figure BLG 2-2 was moved to BLG 2.3.1, and BLG 2.3.2 was added to discuss equity-based compensation awards under ASC 718.
- BLG 2.4.3 was removed as the FASB cancelled the project and the proposed ASU related to simplifying the current versus noncurrent classification of debt in a classified balance sheet.

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Chapter 1: An introduction to bankruptcy proceedings—updated October 2022
1.1 **An introduction to bankruptcy proceedings: Chapter overview**

Each year, thousands of businesses in the United States file for bankruptcy. The reasons vary. In some cases, the bankruptcy process provides an opportunity to “turn back the clock” and reorganize the enterprise for a more economically feasible future. In other cases, bankruptcy is a way to take what remains of a failing enterprise and distribute its remaining assets to its creditors. Whatever the case, the United States has a legal process that defines the steps that an enterprise, and its creditors, must take once an entity has filed for bankruptcy. The laws are designed to protect both parties in a structured, orderly manner.

Bankruptcy law in the United States was codified under federal law in 1978 under Title 11 of the United States Code (referred to herein as the “Bankruptcy Code”), which provides a uniform federal law governing all bankruptcy cases. Prior to that, bankruptcy law was a mix of state and federal laws, each prescribing different treatments for the debtor and its stakeholders.

This chapter provides a high-level summary of the bankruptcy process.

1.2 **Types of bankruptcy filings**

There are six types of bankruptcy filings under the Bankruptcy Code. Figure BLG 1-1 provides a brief description of the circumstances when each type of filing may be appropriate.

**Figure BLG 1-1**

Types of bankruptcy filings under the Bankruptcy Code

<table>
<thead>
<tr>
<th>Type</th>
<th>Filer</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Chapter 7</td>
<td>Businesses/Individuals</td>
<td>Provides for the orderly liquidation of the assets of the debtor for the satisfaction of some or all of its liabilities to its creditors</td>
</tr>
<tr>
<td>Chapter 9</td>
<td>Municipalities</td>
<td>Provides protection to a municipality from its creditors while it renegotiates a plan to adjust its debts</td>
</tr>
<tr>
<td>Chapter 11</td>
<td>Businesses/Individuals</td>
<td>Allows for reorganization of the business and a “fresh-start,” most likely with reduced liabilities, or in certain cases an orderly liquidation</td>
</tr>
<tr>
<td>Chapter 12</td>
<td>Individuals</td>
<td>Provides for the adjustment of debts of a family farmer with regular income and limited debt</td>
</tr>
<tr>
<td>Chapter 13</td>
<td>Individuals</td>
<td>Provides for the adjustment of debts of an individual with regular income or a qualified small business</td>
</tr>
<tr>
<td>Chapter 15</td>
<td>Ancillary and Other Cross-Border Cases</td>
<td>Allows for cross-border insolvency cases to be governed on a uniform and coordinated basis</td>
</tr>
</tbody>
</table>
Generally, a qualified debtor can file for bankruptcy on a voluntary basis by filing a petition in the Bankruptcy Court (the “Court”). Debtors may be domestic or foreign entities. Holders of claims against a debtor (e.g., creditors) can commence an involuntary bankruptcy case under Chapters 7 or 11 if certain criteria are met.

This guide focuses primarily on bankruptcy proceedings under Chapter 11 of the Bankruptcy Code, which is the most common type of filing for businesses. Bankruptcy proceedings under Chapter 11 are within the scope of ASC 852-10, Reorganizations. See BLG 3.21 for discussion of the application of ASC 852-10 for foreign enterprises during bankruptcy.

In February 2020, the Small Business Reorganization Act of 2019 (SBRA) created a new Subchapter V within Chapter 11. Initially, only businesses with noncontingent debt of less than $2,725,625 could qualify under the SBRA, although the CARES Act increased that limitation to $7,500,000 through March 27, 2022, at which point it reverted to the original amount. Subsequently, in June 2022, the Bankruptcy Threshold Adjustment and Technical Corrections Act was enacted to reinstate the $7,500,000 limitation. The limitation was increased retroactively to March 27, 2022 and will remain in effect until June 21, 2024. Subchapter V is intended to allow qualifying debtors to avail themselves of the benefits of Chapter 11 protection while incurring lower costs, fewer reporting requirements, and less administrative burden during the process. As the ability to use Subchapter V is based on the amount of noncontingent debt, larger businesses with significant contingent liabilities (e.g., litigation) but little or no traditional debt may qualify for Subchapter V.

Bankruptcy proceedings under Chapter 7 of the Bankruptcy Code should follow the guidance in ASC 205-30, Liquidation Basis of Accounting, and are not in the scope of ASC 852-10. The liquidation basis of accounting, including associated reporting considerations, is discussed in BLG 6.

## 1.3 Chapter 11 bankruptcy—the basics

A case filed under Chapter 11 of the Bankruptcy Code is frequently referred to as a reorganization proceeding. Put in its simplest terms, a business that files for Chapter 11 protection is attempting to continue its business without the full burden of debt that existed prior to the proceeding.

In a Chapter 11 proceeding, management usually continues to operate the business and prepares a plan of reorganization (the “plan”) for Court approval. In addition, prepetition liabilities are usually stayed and not permitted to be paid unless approved by the Court. Claims are usually paid in order of priority, with the secured claims having the highest priority, followed by administrative claims, then unsecured creditors. Last in line are equity holders, who are usually compromised.

Nearly every type of business enterprise, as well as individuals, can file for protection under Chapter 11 if they meet the criteria set forth by the Bankruptcy Code. Not all enterprises that enter a Chapter 11 bankruptcy will later exit as newly reorganized entities. As discussed later in this chapter, as a case progresses, it is not unusual for a planned reorganization to evolve into a Court-approved sale of some or all of the debtor’s assets or a liquidation of its assets.

## 1.4 Chapter 11 bankruptcy—the players

The debtor is at the center of a Chapter 11 proceeding. It is the entity that seeks to be reorganized and will either emerge from the process with greatly improved chances for its continued existence or have its assets liquidated for the complete or partial satisfaction of its obligations. The considerations for
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the debtor’s continued existence involve determining whether it is likely that the emerging entity can operate without the need for further financial reorganization.

In most cases, the debtor becomes a “debtor-in-possession” following the filing of the petition for bankruptcy. This term refers to a debtor that will keep possession and operational control of its assets in the ordinary course of business while continuing to manage the business and, if necessary, the liquidation process, albeit supervised by the Court during the bankruptcy proceedings. The debtor-in-possession has certain fiduciary duties, as set forth in the Bankruptcy Code and Federal Rules of Bankruptcy Procedure, including accounting for property, examining and objecting to claims, and filing informational reports as required by the Court. The debtor-in-possession also has many of the powers and duties of a trustee, including the right, with the Court’s approval, to engage attorneys, financial advisors, accountants, appraisers, claims agents, or other professionals to assist it during its bankruptcy case. Other responsibilities include filing any other financial reports required by the Court following the proceedings, such as a final accounting.

**Question BLG 1-1**

How does a debtor-in-possession manage an entity in bankruptcy?

**PwC response**

While the law allows management of an entity in bankruptcy to continue to manage its business during the proceedings, there are differences from how the business was operated before the bankruptcy. For example, the debtor must separate its liabilities into those occurring before and after the bankruptcy filing. Those that existed prior to the filing, also known as prepetition liabilities, cannot be paid without specific Court approval. In most cases, the debtor also must open new bank accounts and perform other duties to separate the business arrangements that arose prior to the filing—creating new customer accounts for utilities, for example. Often, the debtor will mark its correspondence during the proceedings to identify itself as a “debtor-in-possession.” Management also has limited authority to perform duties that it might have considered to be in the ordinary course prior to the filing, such as a purchase or sale of significant assets or approval of certain compensation arrangements. In many cases, these activities will require Court approval, as the Court will decide whether there will be a benefit to the ongoing entity or an expense to the detriment of the creditors of the debtor.

In some cases, the Court may assign a case trustee to manage the property of the estate and operate the debtor’s business during the proceedings, but these assignments are rare. Case trustees are usually assigned only for cause, which may include fraud, dishonesty, incompetence, or gross mismanagement. Examiners can also be appointed to assist with investigations, if needed.

The Court accepts the petition for bankruptcy and rules on all aspects of the proceedings. Eventually the Court confirms the final plan of reorganization, or approves alternative actions, and closes the proceedings.

The US Trustee is the administrative arm of the Court and is responsible for overseeing the bankruptcy process by monitoring the compliance of the debtor-in-possession with the applicable reporting requirements, bankruptcy laws, and procedures. The US Trustee also monitors the debtor’s operation of the business and has the ability to object to the debtor-in-possession’s motions before the Court.
The creditors generally fall into four main classes—secured, administrative, priority unsecured, and general unsecured. However, the actual number of classes included in a debtor's reorganization plan may be greater depending on the debtor's particular facts and circumstances. The four main classes are described in Figure BLG 1-2, and listed in the usual order of priority for payment in a typical Chapter 11 bankruptcy proceeding.

**Figure BLG 1-2**
Main classes of creditors in a typical bankruptcy proceeding

<table>
<thead>
<tr>
<th>Class</th>
<th>Description</th>
</tr>
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<tbody>
<tr>
<td>Secured creditor</td>
<td>Holds claims secured by validly perfected security interests in assets of the debtor to the extent of the value of the related collateral</td>
</tr>
<tr>
<td>Administrative creditor</td>
<td>Holds claims to full payment for services provided to the debtor during the post-petition period of the bankruptcy proceedings—also includes vendors who have delivered inventory to the debtor within 20 days of the filing</td>
</tr>
<tr>
<td>Priority unsecured creditor</td>
<td>Holds claims in areas specifically entitled to priority over other unsecured claims such as wages, benefits, critical supplies, and some tax claims</td>
</tr>
<tr>
<td>General unsecured creditor</td>
<td>Holds claims in all other areas for debts arising prior to the petition date, such as general trade payables and other unsecured debts</td>
</tr>
</tbody>
</table>

The determination of the different classes of creditors is significant, as is the process of collecting and evaluating claims. No payments can be made to a subordinate class unless the prior class has been paid in full or otherwise settled in an equitable manner as determined by the Court. This is known as the absolute priority doctrine.

A creditor committee is typically formed to represent the rights of one or more classes of creditors for the purpose of achieving the maximum recovery for the unsecured creditors. This committee is formed by the US Trustee and generally includes the holders of the largest unsecured claims and may include other claim holders as necessary to form a representative group. Some of a creditor committee’s responsibilities include:

- Consulting with the trustee or debtor regarding the case administration
- Monitoring the debtor’s operations and suggesting any changes
- Considering the desirability of the debtor’s continued operations over asset sales or liquidation
- Participating in the formulation of the reorganization plan and facilitating the creditors’ voting process to accept or reject the plan
- Performing other services that are in the interest of the creditors
- Requesting the appointment of a case trustee or examiner when necessary

In some cases, committees also may be formed to represent other interested parties, such as employees, secured debt holders, or equity holders. Committees may petition the Court to change the
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course of the bankruptcy proceedings with the intent to better protect the rights of the interests they represent. For example, committees may be able to use their influence to convert a costly Chapter 11 reorganization into a liquidation proceeding or asset sale that would be more advantageous to committee members’ interests. Whatever action is taken, committees have significant influence over the proceedings and have fiduciary duties to protect those they represent.

The equity holders hold the equity in the debtor at the time of its bankruptcy filing. While the equity holders may have a residual claim to the assets of the debtor, their interests are usually eliminated during a bankruptcy proceeding.

Legal counsel, accountants, and other advisors are critical to the debtor during the bankruptcy process. In most cases, the debtor and each of its committees have separate representation, all at the expense of the debtor. As the bankruptcy plays out in the Court system, counsel will advise its client as to proper process and assist in the negotiations between the debtor and the other various parties in interest. In addition, accountants are often engaged to assist the debtor with its preparation of the monthly financial reports and the various accounting and valuation challenges that occur prior to, during, and upon emergence from the bankruptcy proceedings. Tax advisors are often involved in assisting the debtor with contemplation of certain bankruptcy-specific income tax planning considerations, including the tax treatment of debt extinguishment and the post-emergence use of existing tax attributes.

Professionals engaged to assist in bankruptcy must be disinterested parties approved by the US Trustee prior to performing work for the debtor. The application for retention filed with the Court needs to include the nature of services to be provided to the debtor, the proposed fee structure, any payments received from the debtor within the 90-day period prior to bankruptcy and any prior relationship with the debtor or the interested parties. Each billing for their services, which often has to be detailed in 1/10th of an hour increments, will be subject to Court approval prior to payment.

Advisors that specialize in restructurings and other areas of the bankruptcy process often play a critical role in helping the debtor navigate the process. In many cases, a chief restructuring officer is retained to work alongside management and assist in the development and execution of the debtor’s reorganization strategy. Financial advisors are usually engaged to prepare cash flow forecasts as prioritizing payments and determining cash needs is critical to the restructuring process. Advisors can also assist with arranging debtor-in-possession financing, as it is common for an entity in bankruptcy to need additional financing to continue its operations, particularly in a lengthy bankruptcy proceeding.

Debtor-in-possession financing is arranged by an entity while under the Chapter 11 bankruptcy process and is often structured as a revolving line of credit or term loan payable upon emergence from bankruptcy. Debtor-in-possession financing is unique from other financing in that it usually has priority over existing debt, equity and other claims. Debtor-in-possession lenders regularly receive one or more protections, including a “super priority” administrative claim (e.g., an administrative expense claim with priority over all other administrative expense claims), a lien on assets that were previously unencumbered, or a junior lien on encumbered assets. Debtor-in-possession lenders may also receive a “priming” lien (e.g., a security interest that is “senior or equal” to an existing lien).
Chapter 11 bankruptcy—the process

A Chapter 11 case begins with the filing of a petition for bankruptcy, either voluntarily by the debtor or involuntarily by its creditors, in any bankruptcy court. Each state, plus the District of Columbia, has a bankruptcy court. The filing usually takes place in the region where the debtor is domiciled. Regardless of the party filing the Chapter 11 petition, the objective in most Chapter 11 filings is to preserve the viability of the operating entity and maximize value to the interested parties. The filing usually includes:

- Schedules of assets and liabilities
- A schedule of current income and expenditures
- A schedule of executory contracts and unexpired leases
- A statement of financial affairs
- A schedule of the debtor's known creditors

Once the petition has been filed, most judgments, creditor collection activities, and repossessions of property for obligations that arose prior to the filing of the bankruptcy petition are stayed. This process, which provides the debtor relief from collection efforts while it reorganizes its business affairs, is known as an automatic stay.

Question BLG 1-2
What is an automatic stay?

PwC response

An automatic stay under Section 362 of the Bankruptcy Code provides the debtor with a period during which most collection efforts of its creditors are suspended. The stay covers a wide range of collection activities, ranging from recurring payments to repossessions of property, and is immediately effective upon filing of the bankruptcy petition. Not all collection activities can be suspended, however, as the Bankruptcy Code includes various provisions to protect the creditors during this period, including the right to request the Court for a motion of relief from the stay or for adequate protection payments. Adequate protection payments are designed to compensate the secured creditor for the loss in value of collateral during the bankruptcy period. This compensation might be in the form of cash payments during the proceedings or through a higher priority claim. Adequate protection payments and the accounting thereof are discussed further in BLG 3.10.2.

Upon filing for bankruptcy under Chapter 11, the debtor (or trustee, as applicable) has the power to recover transfers of money or property made during the period of time immediately prior to the bankruptcy filing date. This is commonly referred to as “avoiding” powers, and allows for a return or disgorgement of payments or property to the debtor, which can then be used to pay all creditors. Generally, the “avoiding” powers are effective for transfers made by the debtor within 90 days of the bankruptcy filing date, with some exceptions. For example, certain state laws allow for a longer period of time, and transfers to insiders, such as relatives, general partners, and directors or officers of the
debtor, may be avoided for up to a year prior to the date the bankruptcy petition is filed. Conveyances within two years of the filing of the petition deemed fraudulent can be voided.

In order to recover the payment or property from an avoided transfer, the debtor may initiate a lawsuit referred to as an adversary proceeding. An adversary proceeding may also be initiated by the creditors, for example, when the debtor has refused a demand by its creditors to avoid transfers to its insiders.

The Bankruptcy Code defines a claim as a right to payment or equitable remedy for failure to perform if the breach gives rise to the right to payment. The debtor's initial filings will usually include a schedule of the debtor's known creditors prepared by the debtor from its records. If the debtor lists the claim, a creditor does not have to provide support for its claim as the debtor's schedule is deemed to constitute evidence of the validity and amount of the claim. Any creditor whose prepetition claim is not listed, listed in an amount that differs from the creditor, or listed as disputed, contingent, or unliquidated, must file evidence of its claim. Claims generally become “allowed” claims if they are not disputed by the debtor during the proceedings. The Court ultimately determines whether a disputed claim is allowed.

Soon after the filing of the petition, hearings are held before the Court where certain matters related to the bankruptcy and the debtor are brought forward for approval. For example, as the debtor is expected to operate its business during the bankruptcy process, the approval of debtor-in-possession financing or payments to critical vendors for some or all of their prepetition liabilities may be necessary. These arrangements are deemed critical and absolutely necessary for the continued operations of the debtor. In return, certain protections are provided to the vendors for continuing to provide inventory, services, or funding for the debtor-in-possession's operations while it is in reorganization. Other items that might be addressed during these early hearings are the approval of employee-related costs and the payment of taxes and other fees. Further, when a company files for bankruptcy, creditors typically seek an injunction preventing the equity holders from engaging in sales of stock or other actions that would limit the use of losses or tax attribute carryforwards. This is often done to preserve favorable bankruptcy tax planning options that may be available when the reorganization occurs.

Subsequent to filing, the debtor must prepare and file monthly operating reports with the Court. The monthly operating report is designed to give interested parties information about the debtor's business operations in order to assist the parties with monitoring the likelihood of a successful reorganization. The Schedule of Receipts and Disbursements is the primary schedule in most reports and provides a detailed reconciliation of funds flow for the period, as well as cumulative petition-to-date amounts. From an accounting perspective, the schedule is similar to a statement of cash flows prepared using the direct method. The reports are usually due on the 20th day after month end. Oftentimes, advisors assist management with preparing the reports.

As the debtor continues to operate after the filing, it will begin preparing its reorganization plan. The reorganization plan represents the path forward for the debtor and the operational and financial changes that are necessary in order to operate as a going concern. In most instances, the plan is prepared by the management of the debtor, usually with a high degree of input from the creditors and their committees. The intent and objective of the plan is to demonstrate to the prepetition claim holders the reasons why they could expect more from executing the plan than from a liquidation of the debtor. The plan sets forth the structure and nature of operations of the emerging entity that would achieve this goal.
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The debtor has the exclusive right for 120 days after the bankruptcy petition is granted to file a plan of reorganization and another 60 days (a total of 180 days) to obtain acceptance by the creditors and equity holders before other interested parties can file an alternative plan. The Court may extend or reduce both time periods on request of any party after notice and hearing, and in many cases, the debtor requests an extension to file its plan of reorganization. When extended, the exclusivity period to file a plan of reorganization cannot exceed 18 months from the filing of the petition; and the period to seek the plan’s acceptance cannot exceed 20 months. Once the exclusivity period has expired, any creditor, trustee, or other party in interest may file a competing plan, which provides the debtor incentive to file a plan within the exclusivity period.

The debtor must decide during the proceedings whether to assume or reject existing contracts. These contracts, which can include leases, labor contracts, or other executory agreements, are terminated upon rejection by the debtor and approval by the Court. Any damages to the counterparty from the termination become unsecured claims. These damages are often calculated by formulas used by the Court for leases and other common contracts. In other cases, damages are determined through negotiations and hearings before the Court. If the debtor decides to assume (not reject) a contract, the contract terms will continue, and the debtor must become current on all past due payments and remain current throughout the proceedings. Finally, given the debtor’s ability to reject contracts in their entirety as part of the bankruptcy process, the debtor may be able to renegotiate its contracts at more favorable terms.

Impairment, as used in the context of a bankruptcy, is a legal term that defines the status of a creditor’s contractual rights in the plan of reorganization. This is not the same use of the word as defined in US GAAP, which usually means an asset’s fair value is less than its carrying amount. For example, as a debtor prepares its reorganization plan, it might determine that it can fully pay all of its creditors in the secured, administrative, and priority unsecured creditor classes. These classes, and the liabilities included therein, would be expected to be reflected as “unimpaired claims” in the reorganization plan. However, assume the last class to be paid, representing the general unsecured creditors, is expected to be paid between 50 percent and 80 percent of their claim amounts. These claims would be reflected as “impaired claims” in the reorganization plan. The plan’s reflection of the different classes of claims provides visibility to the creditors and other parties in interest as to how their claims might be resolved if the plan is confirmed.

After filing the plan with the Court, the proponents of the plan will seek its acceptance by a vote of the creditors. The information given to those entitled to vote on the plan is contained in a document referred to as the disclosure statement. The disclosure statement is usually prepared by the debtor and cannot be distributed until the Court approves it as well as the adequacy of the reorganization plan. The Bankruptcy Code does not contain specific disclosure requirements for the disclosure statement, but the document is generally expected to include sufficient information to enable creditors to make an informed judgment about the fairness and appropriateness of the plan.

The disclosure statement usually includes the following:

- Information about the history of the company and the causes of its financial difficulty
- Historical financial information, including the financial statements for at least the year before the petition was filed and the financial statements for the period the company has been in Chapter 11
- A summary of the plan of reorganization
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☐ Prospective financial statement information, including cash projections that will be used to calculate the reorganization value of the debtor

☐ A pro forma balance sheet based on the reorganization value of the company, showing the expected financial structure when it emerges from Chapter 11

☐ An estimated range of the reorganization or enterprise value as calculated by the debtor, and related disclosures and support for the valuations

☐ A summary of the debtor’s proposed exit financing vehicles, including the key terms and provisions, amended credit facilities and, if applicable, equity rights offerings

☐ Information about the current and future management of the company, including the makeup of the Board of Directors

☐ A statement showing the amount creditors would be expected to receive if the company was liquidated rather than reorganized—known as the “Best Interest Test”

☐ A summary of the key points from the business plan that describes the future operations of the debtor

Once the disclosure statement is approved by the Court, the reorganization plan (or a Court approved summary), the disclosure statement, the time frame and ballot necessary to vote on the plan, the date to confirm the plan, and any other relevant material is provided to creditors and equity security holders. Claim holders are usually classified as secured creditors, unsecured creditors with priority, general unsecured creditors or equity holders. Following a solicitation period, each class of claim holders may vote on the reorganization plan. Each impaired class will vote independently, as a class, to accept or reject the plan. Acceptance of the plan by a class of claim holders has occurred if both of the following approvals have been met:

☐ At least two-thirds in dollar amount of allowed claims in the class

☐ More than one-half in number of the allowed claims in the class

Since equity holders generally receive little, if any, value in the reorganization plan, they are often deemed to reject the plan and their vote is not necessary. Similarly, impaired creditors who will not receive any consideration under the plan are deemed to reject it. In contrast, unimpaired classes are deemed to accept the reorganization plan.

Subsequent to balloting stakeholders, the Court will hold a hearing to determine whether to confirm the plan. Even if all classes of creditors do not approve the plan, under certain conditions, the Bankruptcy Code allows the Court the latitude to confirm a plan of reorganization under what is referred to as “cram down” provisions. This action binds all creditors and equity holders to the terms of the plan, even if their respective classes did not approve the plan, were impaired under the plan, or were not addressed by the plan. Under the “cram down” provisions, the Court may confirm a reorganization plan as long as one class of non-insider, impaired claimholders has voted to accept the plan, and the Court finds the plan is fair and equitable and does not discriminate unfairly to each nonconsenting class impaired by the plan.
If the creditors vote in favor of the plan, the debtor can request confirmation of the plan by the Court. The Court will confirm the plan if it determines that the plan is feasible, proposed in good faith, and complies with the Bankruptcy Code. In order to satisfy the feasibility requirement, the Court must find that confirmation is not likely to be followed by liquidation or the need for additional financing to carry out the reorganization plan.

The confirmation date is the date the Court approves the plan of reorganization. Confirmation of the plan by the Court allows the debtor to emerge from the reorganization process, binds the debtor to the provisions of the plan, vests property of the bankrupt estate with the debtor, and discharges the debtor from prepetition liabilities as set forth in the plan. The plan also creates new contractual rights that replace or supersede prepetition contracts.

The Court will set an effective date for emergence, which can be a specified date or a date when all material conditions precedent to the plan becoming effective are met. At that time, the debtor has emerged from bankruptcy. The effective date is also referred to as the emergence date.

### 1.6 Prearranged and prepackaged bankruptcies

Sometimes an enterprise will file a petition in the Court for a prearranged Chapter 11 reorganization. In most cases, this simply means that the enterprise and its significant creditors have agreed on the terms of the reorganization plan prior to the filing of the petition with the Court. Other times, the parties may have taken the extra step of completing the reorganization plan and arranging for voting by the creditor classes prior to filing. This is referred to as a prepackaged bankruptcy.

Prearranged and prepackaged bankruptcies are done to save time and expense as the bankruptcy process generally is time consuming and involves significant costs. A prepackaged bankruptcy may allow the debtor to avoid certain legal and other professional fees associated with the reporting obligations and related disclosure statements and schedules which are often found in a more common bankruptcy filing. However, the legal requirements of prearranged and prepackaged bankruptcy filings, including the Court’s confirmation of the plan, are no different from a standard bankruptcy filing. For this reason, prearranged and prepackaged bankruptcies fall within the scope of ASC 852.

If a prepackaged plan (i.e., prior to filing with the Court) involves an offer to sell securities, a registration statement may have to be filed with the SEC before the vote on the plan by stakeholders.

### 1.7 Bankruptcy timeline

Although every bankruptcy case will have its own unique timeline, some key dates are set by statute and are reasonably predictable. The timeline in Figure BLG 1-3 provides some general guidance as to how a common reorganization case under Chapter 11 might move through the process. Prepackaged and prearranged bankruptcies would operate on a more compressed timeline given the anticipated approval by the creditors.
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Figure BLG 1-3
Timeline for a common reorganization under Chapter 11

**Prior to petition**
A company should engage professional advisors to assist with the various filing and other legal requirements that will need to be met throughout the bankruptcy process if it determines that a bankruptcy filing is its best course of action.

Certain payments and transfers made in the period prior to the petition date may be considered preferential transfers which would be subject to clawback provisions. See BLG 1.12 for additional discussion around preferential transfers.

**Petition date**
The date the petition for bankruptcy is filed with the Court.

**Within 45 days after petition date**
During this time, in most cases, the initial meeting of creditors will take place. This is known as a “341 meeting,” named after the applicable section of the Bankruptcy Code.

**Bar date**
The date set by the Court by which all creditors that have claims against the debtor have to file information to support the validity of their claims. If the debtor has included the claims in its initial schedules as a valid obligation, the creditors need not file additional information unless the creditor believes the debtor’s information is inaccurate. Multiple bar dates may be assigned for different classes of claims.

**120 days after petition date**
Unless extended by the Court, the debtor’s plan of reorganization and disclosure statement must be filed by this date.

**180 days after petition date**
If the debtor’s plan has not been confirmed by this date (after considering any extensions for filing the plan of reorganization), its creditors, trustees, or other parties in interest can file competing plans.

**Solicitation and voting**
The debtor’s plan of reorganization is distributed to creditors and others, and each class of creditors votes to accept or reject the plan.

**Confirmation date**
The date the Court approves the plan of reorganization.

**Emergence date**
The date, on or after the confirmation date, when the reorganization plan becomes effective and all material conditions for emergence have been satisfied. The emergence date is also referred to as the effective date.

1.8 **Alternative endings for Chapter 11 bankruptcy cases**

Many entities that enter the Court system with the intent of reorganization do not exit the process as a reorganized entity. Entities may, by their own choice, under pressure from creditors, or due to the lack of post-emergence financing, use the Chapter 11 process as a vehicle to liquidate the business. The critical difference between liquidation under Chapter 11 and Chapter 7 (the portion of the Bankruptcy Code that governs liquidations) is that under Chapter 11 the entity’s management can often continue to manage the business as well as the liquidation process, albeit supervised by the Court. The Court will determine under which chapter the liquidation will take place by considering whether the legal requirements of a Chapter 11 case can be met. One criterion that would be considered is whether the
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Entity has sufficient funds to pay its administrative claims (also referred to as administrative expenses)—these must be satisfied in order for confirmation to take place. If the legal requirements cannot be met, the Court may convert the case to a Chapter 7 liquidation and the operation of the enterprise will be transferred to an independent trustee. The Chapter 7 process is covered in BLG 1.9.

Liquidations of enterprises that enter Chapter 11 may be attributed to several factors. First, changes in the Bankruptcy Code have moved certain claims to a higher priority. Inventory delivered to a debtor in the 20 days prior to the filing for bankruptcy (known as a “503(b)(9) claim”), for example, was given administrative claim status under a change in the Bankruptcy Code in 2005. Administrative claims must be paid in full prior to confirmation of a reorganization plan. This is often a challenge for cash-strapped enterprises, which can make liquidation more likely. Second, some enterprises may have difficulty obtaining debtor-in-possession financing or, in those cases where it can be obtained, an entity cannot obtain such financing on terms that are considered economically feasible to the ongoing entity. Finally, in many cases, creditors are not willing to wait for a long reorganization process—one that will likely consume significant financial resources of the entity—when they can force liquidation of the entity and receive payment sooner and potentially in a greater amount.

In addition to the liquidation options under the Bankruptcy Code, a sale of some or all of the entity's assets may be the best course of action for the benefit of the creditors. In such a sale, which could be as part of the reorganization plan or through an asset sale known as a Section 363 sale, the Court would approve the sale of all or part of the estate and the funds would be used to satisfy creditors. Often a Section 363 sale, the process for which is described in BLG 5.2.1, will leave behind liabilities and, in certain instances, assets that are not included in the sale which will be liquidated for the benefit of creditors.

1.9 Chapter 7 bankruptcy

An entity may have financial issues so significant that it does not expect a Court would be able to affirm its future feasibility as a going concern (i.e., the entity does not have any value beyond its identifiable net assets). Upon the filing of a petition under Chapter 7 of the Bankruptcy Code, the Court assigns an independent trustee to manage the business and the process of liquidation. This is a significant difference from a petition under Chapter 11 where the debtor generally retains at least some of the rights to control its own assets. The trustee will usually discontinue the entity's operations to conserve its remaining resources and sell its assets to the highest bidder using the proceeds of sale for the benefit of the creditors. Secured creditors generally will receive a return of their collateral. Administrative claims are usually paid first, and any remaining proceeds are paid to the remaining creditors according to the provisions of the Bankruptcy Code. Upon completion of the process, the debtor receives a discharge from its prepetition debts.

1.10 Chapter 9 bankruptcy

A financially distressed government municipality which seeks protection from its creditors while it develops and renegotiates a plan for adjusting its debts may file for bankruptcy under Chapter 9 of the Bankruptcy Code. Examples of government municipalities that may file under Chapter 9 include cities, towns, villages, counties, taxing districts, municipal utilities, and school districts. States cannot use Chapter 9. Although a Chapter 9 filing is similar to a Chapter 11 filing in certain respects, there are some key differences:
There is not a provision for the liquidation of the bankrupt entity’s assets and subsequent distribution of the proceeds to its creditors.

The Court is limited in its role of overseeing the bankruptcy process, as it is restricted by the Tenth Amendment to the US Constitution, which provides sovereignty to the states and limits the Federal government’s ability to interfere with states’ rights. Typically, the Court’s involvement under Chapter 9 is limited to approving the bankruptcy petition, confirming a plan of debt adjustment, and ensuring implementation of the municipality’s plan for emergence.

1.11 Chapter 15 bankruptcy

Chapter 15 bankruptcies were established under the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005. A Chapter 15 proceeding provides a mechanism for bankruptcies with cross-border implications. Typically, a Chapter 15 proceeding will be ancillary to a bankruptcy proceeding brought about in another country. The statute has the following objectives:

- To promote cooperation and communication between the United States courts and parties in interest with proceedings or claims against the debtor in foreign courts and other parties in interest in cross-border insolvency cases
- To establish greater legal certainty for trade and investment
- To provide for the fair and efficient administration of cross-border insolvencies that protects the interest of all creditors and other interested parties, including the debtor
- To afford protection and maximization of the value of the debtor’s assets
- To facilitate the rescue of financially troubled businesses, thereby protecting investment and preserving employment

1.12 The creditor’s side of the story (bankruptcy)

Although this guide has been developed from the perspective of the debtor, a bankruptcy filing may have a significant impact on the various parties that have conducted business with an entity that files for bankruptcy. Creditors often move quickly to protect their claims against the debtor. For example, creditors have rights under the Bankruptcy Code to reclaim inventory that was recently sold to or is on consignment with the now-bankrupt entity. Creditors will need to give careful consideration to their estimates of collectability for receivables from a customer that filed for bankruptcy. Even if the creditors’ claims are fully secured, there is risk that receivables may not be repaid in full and often times such receivables may be settled for considerably less than their stated amounts. In addition, the Bankruptcy Code has provisions for protecting physical assets that are in use by a bankrupt customer or supplier. When a company has guaranteed the debt of an entity that has filed for bankruptcy, it should evaluate whether a liability for the guarantee should be established, or, if the company has already established a liability, whether the liability should be adjusted.

On the other hand, certain payments received from the bankrupt entity in the period prior to the filing of the petition (typically 90 days) may have to be remitted back to the debtor. These items, known generally as preferential transfers, allow the Court to protect the interests of all creditors with claims in the bankruptcy proceedings. For example, a debtor in the days prior to the filing may pay some
vendors while withholding payment from others. The preferential transfer provisions in the Bankruptcy Code provide for those funds to be returned to the debtor so that an equitable disbursement can later be made. A debtor would generally record a receivable from the payee when the Court approves the return of the original payment and a corresponding liability subject to compromise, representing the expected claims to be filed by the payee, since it was forced to return its original payment.

While the intent of the process is understandable, it can create cash flow issues for an entity that is forced to return funds it received from the debtor even though the services or inventory that it provided to earn those funds cannot be recovered. As with the debtor, counsel is critical in protecting a creditor's best interests as there are defenses against remittance of funds for preferential transfers.
Chapter 2: Accounting and reporting considerations prior to entering bankruptcy—updated October 2022
2.1 **Financial distress prior to entering bankruptcy**

In some cases, a reporting entity may file for bankruptcy because of a single event, such as a significant unfavorable litigation judgment or other severe financial event. In other cases, a bankruptcy is preceded by a continued decline in financial condition that gives rise to certain accounting considerations that might not be present when a reporting entity is profitable. Some of the indicators of financial distress include:

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<tr>
<td>Market share</td>
<td>Management and employee turnover</td>
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<tr>
<td>Revenue / EBITDA</td>
<td>Unit costs</td>
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<td>Margins</td>
<td>Competition</td>
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<td>Liquidity</td>
<td>Shareholder pressure</td>
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<td>Dividends</td>
<td>Creditor pressure</td>
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<td>Capital expenditures</td>
<td>Leverage ratios</td>
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<td>Credit ratings</td>
<td>Risk of debt covenant defaults</td>
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<td>Demand for product/services</td>
<td>Collateral requirements</td>
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While this guide focuses on accounting and reporting considerations for an entity in bankruptcy, this specific chapter highlights items for any reporting entity to consider when it is experiencing significant financial difficulties. As such, users of this guide should also review the applicable US GAAP and PwC Guides referenced herein for further information regarding these and other items that may be impacted when a reporting entity is in financial distress.

2.2 **Asset impairments (pre-bankruptcy)**

Generally, a bankruptcy filing is not the first triggering event for an impairment assessment. Asset impairments usually precede a bankruptcy filing given the financial decline that a reporting entity typically faces, which may also be experienced throughout the industry in which it operates. Impairments are usually associated with declines in the reporting entity's cash flows from operating activities and a corresponding decline in the fair values of underlying assets. See BLG 2.2.1 through BLG 2.2.8 for important considerations regarding asset impairments in advance of a bankruptcy filing.

2.2.1 **Goodwill (pre-bankruptcy)**

Public business entities that are SEC filers, excluding smaller reporting companies as defined by the SEC, are required to measure a goodwill impairment loss as the amount by which a reporting unit’s carrying amount exceeds its fair value, not to exceed the carrying amount of goodwill. The current guidance was issued by the FASB in January 2017 as Accounting Standards Update 2017-04, *Intangibles – Goodwill and Other (Topic 350): Simplifying the Accounting for Goodwill Impairment*. 

Accounting and reporting considerations prior to entering bankruptcy

(ASU 2017-04), which eliminated the need for a hypothetical purchase price allocation to measure goodwill impairment.

All other entities that have not elected the accounting alternative to amortize goodwill, discussed further below, will be required to apply the guidance in fiscal years beginning after December 15, 2022. Early adoption is permitted; however, early adoption in a fiscal year is precluded if an impairment test earlier in that fiscal year applied the prior impairment guidance.

ASU 2017-04 also amended the testing for reporting units with zero or negative carrying amounts, and includes a new requirement to disclose the amount of goodwill attributed to these reporting units. See BCG 9.6.5 for goodwill impairment testing considerations for reporting units with zero or negative carrying amounts prior to the adoption of ASU 2017-04 and BCG 9.8.1.3 for considerations subsequent to the adoption of ASU 2017-04.

Private companies and not-for-profit (NFP) entities are eligible to make an accounting policy election for the following accounting alternatives related to goodwill:

- Amortize goodwill on a straight-line basis over 10 years, or less than 10 years if the entity demonstrates that a shorter useful life is more appropriate (“goodwill alternative”) (see BCG 9.11.1)

  Evaluate goodwill impairment triggering events as of the end of a reporting period (whether interim or annual) rather than throughout the reporting period (see BCG 9.11.2)

An entity is not required to elect either of the alternatives and is not precluded from electing, or required to elect, one of the alternatives if it elects the other alternative. Private companies that have elected the goodwill alternative but not the Private Company Council (PCC) alternative to subsume certain intangible assets into goodwill (ASU 2014-08) have a one-time election to adopt ASU 2017-04. See BCG 9.11.1.5 for additional information. A company that meets the definition of a public business entity, as well as employee benefit plans, are not eligible to apply the PCC alternatives.

The remainder of this section addresses the goodwill impairment considerations for entities not following the PCC alternatives discussed above. An entity is required to test the carrying amount of a reporting unit’s goodwill for impairment on an annual basis in accordance with ASC 350-20-35-28. Under ASC 350-20-35-30, an entity should also test goodwill for impairment between annual tests if an event occurs or circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying amount. ASC 350-20-35-3A defines “more likely than not” as “a likelihood of more than 50 percent.”

While ASC 350-20-35-3C(a) through 35-3C(g) provide examples of such events and circumstances (i.e., triggering events), a reporting entity should consider all available information when performing its qualitative goodwill impairment assessment as required by ASC 350-20-35-3F.

The AICPA’s Accounting and Valuation Guide, *Testing Goodwill for Impairment* (“AICPA Goodwill Guide”), includes helpful examples of events and circumstances that might trigger the need for an interim goodwill impairment test. The SEC staff has also provided the following examples of events that may indicate that an interim impairment test is necessary:
Accounting and reporting considerations prior to entering bankruptcy

- Impairments of other assets or the establishment of valuation allowances on deferred tax assets
- Cash flow declines or operating losses at the reporting unit level (the greater the significance and duration of losses, the more likely it is that a triggering event has occurred)
- Negative current events or long-term outlooks for specific industries impacting the reporting entity as a whole or specific reporting units
- Failure to meet analysts expectations or internal forecasts in consecutive periods or downward adjustments to future forecasts
- Planned or announced plant closures, layoffs, or asset dispositions
- Market capitalization of the reporting entity below its book value

Based on its qualitative assessment, if a reporting entity concludes that it is more likely than not that the fair value of a reporting unit is greater than its carrying value, then quantitatively testing goodwill for impairment is not necessary. See BCG 9.6 for more information on the qualitative goodwill impairment assessment.

Alternatively, if the qualitative assessment indicates it is more likely than not that a reporting unit’s fair value is less than its carrying value, quantitative impairment testing must be performed in accordance with ASC 350-20-35. See BCG 9.5 and BCG 9.8 for more information on the goodwill impairment model and the quantitative goodwill impairment test, respectively.

### 2.2.2 Indefinite-lived intangible assets (pre-bankruptcy)

ASC 350, *Intangibles–Goodwill and Other*, addresses impairments of indefinite-lived intangible assets. An indefinite-lived intangible asset is considered to be impaired when the asset’s carrying amount exceeds its fair value, as defined in ASC 360, Property, Plant, and Equipment. There are various approaches to determine whether an impairment should be recognized and, if so, how to measure and record such impairment in the financial statements. The identification of the applicable impairment approach is an important part of assessing and measuring an asset’s impairment.

The carrying amounts of any long-lived assets (including indefinite-lived intangible assets) that are not in the scope of ASC 360-10, other than goodwill, should be tested for impairment prior to testing long-lived assets for impairment, as discussed further in BLG 2.2.3. The order described therein for long-lived assets that are held and used differs from the held-for-sale impairment model discussed in BLG 2.2.4. Consistent with the goodwill impairment test previously discussed, ASC 350 allows an entity to first assess qualitative factors to determine whether events and circumstances indicate that it is more likely than not that an indefinite-lived intangible asset is impaired.

See BCG 8.3 for additional information regarding the indefinite-lived intangible asset impairment model.

### 2.2.3 Long-lived assets to be held and used (pre-bankruptcy)

Unlike goodwill and indefinite-lived intangible assets, which are required to be tested for impairment at least annually, ASC 360-10 does not require annual impairment testing for long-lived assets that are held and used. Instead, a long-lived asset (asset group) that is held and used should be tested for
recoverability whenever events or circumstances indicate that the carrying amount of the long-lived asset (asset group) may not be recoverable. Examples of such events or changes in circumstances, commonly referred to as impairment indicators or triggering events, are detailed in ASC 360-10-35-21. The examples provided should not be considered the only potential indicators that an asset (asset group) may not be recoverable.

When a reporting entity identifies an impairment indicator, it should perform a recoverability test, which is the first of two steps in the impairment test of long-lived assets. An asset (asset group) is considered to be recoverable when the entity-specific, undiscounted cash flows expected to be generated from the use and eventual disposition of the asset (asset group) are greater than its carrying amount. Depending on the reporting entity’s facts and circumstances, the use of an expected cash flow approach using a probability-weighted average of all possible cash flows, or the use of a single set of cash flows representing management’s best estimate of the most likely outcome within a range of possible estimated amounts, may be appropriate. PPE 5.2.4.3 discusses this in more detail.

If the asset (asset group) is not recoverable (i.e., the net carrying value exceeds the entity-specific, undiscounted net cash flows), an impairment loss should be recognized based on the amount by which the carrying value of the asset (asset group) exceeds its fair value, which should be calculated based on the guidance in ASC 820-10.

The carrying amounts of any assets in the asset group that are not within the scope of ASC 360-10 (e.g., accounts receivable, inventory, indefinite-lived intangible assets other than goodwill) should be tested for impairment in accordance with other US GAAP prior to performing the impairment test on the long-lived assets (asset group). The carrying values are adjusted, if necessary, for the result of each impairment test prior to performing the next test. The determination of a reporting entity’s asset groups involves judgment and all relevant facts and circumstances should be considered. See PPE 5.2.1 for additional information on making this determination.

As discussed in PPE 5.2.4.11, reporting entities should evaluate whether a bankruptcy filing impacts management’s intended use of such assets (e.g., will they continue to be operated for their remaining useful lives beyond the expected emergence from bankruptcy or sold during bankruptcy to provide liquidity). Even before the filing, significant operating or cash flow losses that typically precede a bankruptcy filing would often trigger an impairment assessment of the long-lived assets. The cash flow forecasts used to test for recoverability would consider the likelihood of various outcomes, including whether a bankruptcy filing will occur and, if so, how that filing might impact the future cash flows and operations of the asset group. If a reporting entity is having difficulty financing its operations and if customers are unwilling to purchase from, or suppliers are unwilling to sell to the reporting entity because it is considering bankruptcy, these factors would impact the cash flow projections used in the recoverability test for long-lived assets. A probability-weighted cash flow analysis based on the facts and circumstances as of the trigger date is often used to assess recoverability when various outcomes, such as continued operation, sale, liquidation, or operating and emerging from bankruptcy, are considered.

Reporting entities should consider the appropriate disclosures when a bankruptcy filing occurs after the balance sheet date but before the date the financial statements are issued or available to be issued. Bankruptcy as a subsequent event is discussed in BLG 2.11. Additionally, as discussed in PPE 5.2.4.1, cash flow estimates should not be adjusted for a subsequent bankruptcy filing (i.e., cash flow estimates should reflect conditions and assumptions that existed as of the measurement date).
The method of depreciation and the remaining useful lives of a reporting entity’s long-lived assets should also be evaluated when impairment tests are performed even if the asset (asset group) is determined to be recoverable. For example, this evaluation may indicate that the anticipated life of a manufacturing facility should be shortened in light of reduced production volumes, resulting in increased depreciation over the remaining term.

See PPE 5.2 for further discussion of the impairment model for long-lived assets to be held and used.

### 2.2.4 Long-lived assets to be disposed of by sale (pre-bankruptcy)

Companies progressing toward bankruptcy often sell assets or dispose of noncore operations to increase liquidity. The primary guidance applicable to the disposal of long-lived assets is ASC 360, which addresses the determination of the disposal group, whether the long-lived assets (disposal group) should be reported as held for sale, and whether the operations of the long-lived assets (disposal group) should be classified as discontinued operations. ASC 360-10-45-9 requires that a long-lived asset (disposal group) should be classified as held for sale in the period in which all of the held-for-sale criteria are met. All criteria must be met as of or prior to the balance sheet date for a long-lived asset (disposal group) to qualify as held for sale.

If all of the criteria are met, the asset (disposal group) should be measured at the lower of its carrying amount or fair value less costs to sell. Depreciation or amortization of long-lived assets included in the disposal group is suspended once held-for-sale classification has been met. Further, consideration should be given to the criteria in ASC 205-20, Discontinued Operations, to determine whether discontinued operations classification is appropriate. See FSP 27.3 for further discussion.

See PPE 5.3.1 for further discussion of the held-for-sale accounting model and PPE 6 for asset dispositions.

### 2.2.5 Leases (pre-bankruptcy)

As previously mentioned, a reporting entity should evaluate whether a potential bankruptcy filing will impact its intended use of long-lived assets, which includes right-of-use assets accounted for under ASC 842, Leases. See LG 5 for a discussion of the accounting if a lessee makes modifications, including terminations, to its leases.

Reporting entities may also experience significant operating or cash flow losses prior to a bankruptcy filing that may trigger an impairment assessment. As discussed in PPE 5.2.7, a reporting entity should include the carrying value of any right-of-use asset in an asset group for purposes of impairment testing in accordance with ASC 360.

Reporting entities that have not yet adopted ASC 842 should follow the guidance within ASC 840, Leases, discussed in LG 10.4 and LG 10.5 for lessees and lessors, respectively.

### 2.2.6 Inventories (pre-bankruptcy)

A bankruptcy filing is typically preceded by reduced sales volume, declining gross margins, and reduced operating profits. Entities should consider the impact of these declining operating results on inventories and whether any inventory reserves are needed. For example, a decline in product gross margin resulting from reduced sales prices or higher costs may indicate that an inventory reserve is necessary to reduce the carrying value of inventory to net realizable value. Inventory quantities might
also be in excess of forecasted sales volumes given the overall sales pipeline and projections. This could result in the need for a reserve for excess or obsolete quantities. Consistent with the view of the SEC staff, the impact of write-downs on inventory should be classified as cost of goods sold on the statement of operations, even when the inventory reserves are directly associated with a reporting entity’s restructuring activities.

Another important area for companies to consider prior to a bankruptcy filing is whether under-absorbed overhead or production costs should be expensed when production volumes decrease due to reduced demand or unplanned facility downtime. When production levels are determined to be abnormally low, the portion of the fixed production overhead attributable to the underutilized capacity should not be allocated to and capitalized as a cost of inventory. Rather, it should be recognized as an expense (within cost of goods sold) in the period in which it is incurred. Judgment is required to determine when a production level is abnormally low—that is, outside the range of the expected variation in production. See IV 1.4 for further discussion of full absorption costing and IV 1.5.7 for further discussion of cost of goods sold.

2.2.7 Accounts receivable, contract assets, and supply agreements (pre-bankruptcy)

Entities proceeding toward a bankruptcy filing may find it increasingly difficult to collect outstanding receivables. As customers become aware of the financial difficulties of a reporting entity, they may have concerns that certain support or warranty obligations may not be performed, and therefore delay or withhold payments until the financial viability of the reporting entity is more certain.

A reporting entity experiencing financial distress or operating in a distressed industry should consider a customer’s credit risk as it relates to measuring impairment losses for accounts receivable and contract assets based on guidance in ASC 310, Receivables (credit losses are determined based on the guidance in ASC 326, Financial Instruments – Credit Losses, once adopted). For example, management may make billing adjustments, such as changes in the transaction price of its goods or services, or it may need to update its estimate of collections for previously satisfied performance obligations. Reporting entities should consider whether an adjustment represents a change in revenue or represents an adjustment to the measurement of the receivable or contract asset under ASC 310 (ASC 326, once adopted). See RR 4.2 for additional information.

Reporting entities progressing toward a bankruptcy filing may also amend existing customer supply agreements, which may result in revenue-related accounting issues under ASC 606, Revenue from Contracts with Customers.

2.2.8 Investments (pre-bankruptcy)

Reporting entities should periodically assess their investments for declines in value. Entities in troubled industries with investments within that industry are more likely to experience declines in investment values, which may result in the recognition of impairment charges. Circumstances leading to an investee considering a bankruptcy filing would likely trigger an impairment assessment by the investor.

See LI 2 for impairments of investments in equity securities, LI 7 and LI 8 for discussion of the impairment model for investments in debt securities and EM 4.8 for impairments of equity method investments.
2.3 Employee-related matters (pre-bankruptcy)

Restructuring activities prior to a reporting entity entering bankruptcy may involve terminating employees in an effort to improve profitability and liquidity. A reporting entity may also modify or terminate employee stock compensation awards.

2.3.1 Termination benefits (pre-bankruptcy)

The recognition of costs for employee terminations is affected by the type of termination as well as any future service requirements associated with termination benefits to be paid. For example:

- Employee terminations may be voluntary or involuntary
- Termination benefits may be one-time benefits or provided pursuant to an existing arrangement
- Termination benefits may be individually negotiated or determined for a group
- Termination benefits may be vested or may include a future service requirement as a result of the terminating event

Because different types of termination arrangements may fall within the scope of various sections of the ASC with differing measurement and reporting criteria, it is important to understand the guidance that applies in the specific situation. ASC 420, Exit or Disposal Cost Obligations, provides guidance on one-time employee termination benefits. ASC 712-10-25 provides guidance on contractual termination benefits, special termination benefits, and other post-employment benefits.

2.3.2 Equity-based compensation awards (pre-bankruptcy)

In addition to termination benefits, an entity may also modify stock compensation awards to retain employees through the bankruptcy proceedings. Equity-based award modifications follow the guidance in ASC 718, Compensation – Stock Compensation. This guidance is also applicable to cancellations of equity-based awards, which is another common occurrence prior to an entity entering bankruptcy. See SC 4 for further information about equity-based award modifications and cancellations.

Accounting for nonemployee awards is also subject to ASC 718. See SC 7 for further information about stock-based transactions with nonemployees.

2.3.3 Pensions/other post-employment benefits (pre-bankruptcy)

Companies progressing toward a bankruptcy filing should evaluate whether any significant events have occurred that would require a remeasurement of pension or other post-employment benefit obligations. For instance, restructuring activities could result in a plan curtailment, settlement, or significant benefit plan amendment. See PEB 4 for information on pension plan amendments, curtailments and settlements.
2.4 Other contractual arrangements (pre-bankruptcy)

Reporting entities often cancel contractual arrangements as part of restructuring activities, triggering a need to evaluate the appropriate time to recognize the costs associated with any terminations.

In accordance with the guidance in ASC 420-10-25-11, if an entity terminates a contract prior to the end of its term, the liability for termination costs should be recognized and measured at fair value when the reporting entity terminates the contract in accordance with its terms (e.g., when the reporting entity gives written notice in accordance with the contract terms or has otherwise negotiated a termination with the counterparty). A liability for costs that will continue to be incurred under a noncancelable contract (i.e., required under the remaining term) without economic benefit to the entity should be recognized and measured at fair value when the reporting entity ceases using the rights conveyed by the contract.

2.5 Debt (pre-bankruptcy)

Given the deteriorating financial conditions usually associated with companies moving toward bankruptcy, companies might violate covenants (financial and nonfinancial) in existing debt agreements. When a covenant violation is triggered, the debt may become due on demand, or callable, by the lender. Under the guidance in ASC 470, Debt, these obligations may need to be classified as current unless the lender has waived or subsequently lost the right to demand repayment for more than a year (or operating cycle) from the balance sheet date. In other instances, when the long-term obligation agreement contains a grace period provision, the obligation may need to be classified as current unless it is probable that the debtor will cure the violation within the grace period, thus preventing the obligation from becoming callable.

Companies that have violated a covenant but obtained a waiver at period-end should consider whether they will continue to meet the covenant in future periods. If a future violation is probable, the debt should be classified as a current obligation. If compliance with applicable covenants is probable for the next 12 months, the debt obligation should continue to be classified as noncurrent.

Companies should be mindful of the disclosure requirements associated with debt covenant violations and waivers, including specific disclosure requirements for SEC registrants pursuant to Rule 4-08(c) of Regulation S-X.

2.5.1 Debt issuance costs (pre-bankruptcy)

Like debt premiums and discounts, debt issuance costs should be reported as an adjustment to the carrying amount of the related liability. Debt issuance costs are usually amortized to interest expense over the contractual or expected term of the debt in accordance with a reporting entity’s accounting policy. See FG 1.2 for information on issuance costs associated with term debt. Costs associated with entering into a revolving line of credit or a revolving debt arrangement are recorded separately on the balance sheet (as opposed to the contra-liability presentation used for issuance costs for term debt) and amortized on a straight-line basis over the contractual term of the arrangement (i.e., the access period). See FG 1.3 for information on the accounting for issuance costs associated with revolving lines of credit.

When debt is reclassified to short term because of a covenant violation, questions may arise as to the need to write-off the unamortized debt issuance costs as the covenant violation may result in the
shortening of the related life of the debt. Factors to consider when determining whether unamortized debt issuance costs should be written off to expense include:

- Nature and existence of active negotiations between the lender and debtor to secure a waiver or restructure the debt
- Financial condition of the debtor and how likely the lender would be to call the debt and demand repayment rather than grant a waiver or forebear
- History of obtaining prior waivers, if any, from the lender
- Execution of a written forbearance agreement and whether during the forbearance period the parties have agreed to negotiate to restructure the debt

If the debt will not be renegotiated or a waiver will not be obtained, the debt issuance costs should be written off because the debt has effectively become demand debt.

On the other hand, if there is a reasonable likelihood that the debt will be renegotiated or a waiver obtained and the debt will ultimately maintain its long-term nature, the amortization of debt issuance costs should continue as before the violation with adequate disclosure. The unamortized debt issuance costs should continue to be reported as an adjustment to the carrying amount of the related liability if the related debt is classified as short-term. The reporting entity should also disclose the balance of unamortized debt issuance costs that may be required to be written off in the event that a waiver or restructuring of terms cannot be negotiated and the debt is either redeemed or otherwise extinguished.

See FG 1.2.3.3 for considerations related to the amortization of debt issuance costs and debt discounts and premiums when a reporting entity seeks to restructure its outstanding debt obligations.

2.5.2 **Debt extinguishments and modifications (pre-bankruptcy)**

Companies often consider a variety of potential transactions with creditors or security holders to enhance liquidity. The transactions may involve cash settlement, an issuance of equity for debt, an exchange of debt, or modification of debt terms.

When debt instruments are either exchanged or modified, the debtor must first determine whether the exchange or modification meets certain criteria to be considered a “troubled debt restructuring” following the guidance in ASC 470-50, *Debt—Modifications and Extinguishments*. These criteria include assessing whether the debtor is experiencing financial difficulty and whether the creditor has granted a concession. If the criteria are met, a gain is recognized, but only to the extent that the gross cash flows of a new or modified debt instrument are less than the carrying amount of the old debt instrument. If the gross cash flows exceed the carrying amount of the old debt, no gain is recorded and a new effective interest rate is established based on the carrying amount of the debt and the revised cash flows.

If an exchange or modification of an instrument is not a troubled debt restructuring, the debtor must still determine whether the transaction meets the criteria to be considered an extinguishment. If the modified or new debt instrument has substantially different terms from the old debt instrument, an extinguishment is recognized. If the exchange is considered a modification, the effects are generally reported prospectively utilizing a new effective interest rate determined based on the carrying amount
of the original debt and the revised cash flows. Interest expense is recognized using the new effective interest rate.

This topic is discussed further in ASC 470-50, FG 3.3, and FG 3.4.

### 2.6 Financial instruments—derivatives (pre-bankruptcy)

Companies may have hedging strategies in place where they base hedge effectiveness on forecasts of future events or transactions. As companies move toward bankruptcy, these forecasted events or transactions may no longer be attainable or likely to occur. In such cases, the derivative instruments should be reviewed for effectiveness, considering the likelihood or probability of occurrence of the events or transactions underlying the hedging strategy. Consideration should be given to amounts in accumulated other comprehensive income (AOCI) that relate to forecasted transactions that are no longer probable of occurring. If the occurrence of the transaction is in doubt, any related amounts in AOCI may need to be recognized in the statement of operations. The applicable guidance in ASC 815, Derivatives and Hedging, should be considered. For further discussion of this topic, see DH 9.

### 2.7 Income taxes (pre-bankruptcy)

The financial difficulties a reporting entity may experience prior to a bankruptcy filing may have certain income tax accounting consequences, particularly with respect to management’s assertions regarding indefinite reinvestment of foreign subsidiaries, long-term investment nature of intercompany loans, recoverability of investments in domestic subsidiaries, and realizability of deferred tax assets. Such income tax considerations are further discussed in the following sections.

#### 2.7.1 Foreign subsidiaries (pre-bankruptcy)

Reporting entities may assert that book-over-tax outside basis differences attributable to a foreign subsidiary will be indefinitely reinvested and, thus, not provide for parent-level deferred taxes on such earnings under the guidance of ASC 740, Income Taxes. In advance of a bankruptcy filing, however, it may be difficult to continue to support this assertion if the financial condition of a parent is such that at least some of the outside basis difference might need to be repatriated to fund the domestic cash flow needs of the parent. In this instance, a deferred tax liability may need to be established for all or a portion of the foreign subsidiary’s outside basis difference.

Additionally, reporting entities may assert that intercompany loans with foreign subsidiaries are of a long-term investment nature (i.e., settlement is not planned or anticipated in the foreseeable future), which allows for gains and losses on the related foreign currency translations to be excluded from net income. Reporting entities that treat such loans as long-term may assert indefinite reinvestment and not provide for deferred taxes on these gains and losses, which are recognized in other comprehensive income. Similar to the indefinite reinvestment assertion, reporting entities may find it challenging to continue to assert that intercompany foreign currency loans will not be settled in the foreseeable future and may need to recognize gains and losses prospectively in net income and establish deferred taxes on the accumulated foreign currency translation through an adjustment to income tax expense.

#### 2.7.2 Domestic subsidiaries (pre-bankruptcy)

Under the guidance of ASC 740, reporting entities are not required to provide for deferred taxes on outside basis differences in domestic subsidiaries based on an assertion that they have the ability and
intent to recover the amount of their investment in a tax-free manner. In advance of a bankruptcy filing, it may be difficult to continue to support this assertion if, for instance, a disposal of the subsidiary may be required to fund cash flow needs.

2.7.3 Valuation allowance considerations (pre-bankruptcy)

Reporting entities should consider the need for valuation allowances against deferred tax assets in advance of a bankruptcy filing. Given the nature of events that typically precede a bankruptcy filing, including ongoing operating losses, deteriorating credit conditions, etc., it may be more likely than not that the tax benefits from deferred tax assets will not be realized and that a valuation allowance should be recorded. Careful consideration should be given to the reporting entity’s history of operating losses and the impact that a bankruptcy filing could have on the reporting entity’s ability to utilize deferred tax assets in the future. The assumptions, such as earnings projections, used in assessing the realizability of deferred tax assets should be consistent with assumptions used in impairment testing and consideration of the reporting entity’s ability to continue as a going concern. This assessment will often lead to a conclusion that a valuation allowance is required prior to a bankruptcy filing.

The impact on net income from certain changes may be amplified when a full valuation allowance is recorded. For example, charges for items such as long-lived asset impairments that typically give rise to a deferred tax asset will not be reduced by a tax benefit when a reporting entity has recorded a full valuation allowance. For further discussion on valuation allowance assessments see TX 5.

2.8 Consolidation considerations (pre-bankruptcy)

Reporting entities nearing bankruptcy will need to re-evaluate previous accounting determinations reached with respect to consolidation. Specifically, if a reporting entity has relationships with variable interest entities (VIEs) that have been historically consolidated, financial deterioration may give rise to financial restructuring activities or other events to improve the reporting entity’s liquidity. To the extent that these activities involve subsidiaries, which may or may not be experiencing financial difficulties of their own, the need to reconsider the original consolidation conclusion may be necessary. ASC 810, Consolidation, lists a number of reconsideration events of whether or not a reporting entity is still a VIE, including:

- The legal entity’s governing documents or contractual arrangements are changed in a manner that changes the characteristics or adequacy of the legal entity’s equity investment at risk
- The equity investment or some part thereof is returned to the equity investors, and other interests become exposed to expected losses of the legal entity
- The legal entity undertakes additional activities or acquires additional assets, beyond those that were anticipated at the later of the inception of the entity or the latest reconsideration event, that increase the entity’s expected losses
- The legal entity receives an additional equity investment that is at risk, or the legal entity curtails or modifies its activities in a way that decreases its expected losses
- Changes in facts and circumstances occur such that the holders of the equity investment at risk, as a group, lose the power from voting rights or similar rights of those investments to direct the activities of the entity that most significantly impact the entity’s economic performance
Upon a reassessment, a subsidiary may remain a VIE and the parent may continue to be the primary beneficiary, or a different primary beneficiary may be identified, causing the parent to deconsolidate its subsidiary. Although unlikely, upon reassessment, the subsidiary could also be determined to be a voting interest entity. Reporting entities should remember that while the VIE determination is a trigger-based event, the assessment of the primary beneficiary is an ongoing analysis that requires constant monitoring of the facts and circumstances, which may change as an entity progresses through bankruptcy proceedings.

2.9 **Professional fees incurred in advance of bankruptcy filing**

Entities may incur certain professional fees in anticipation of a bankruptcy filing. Examples include legal fees incurred in preparing a bankruptcy filing or appraisal fees for valuation experts. Such expenses should be recognized in income when the associated services are rendered rather than deferred until a bankruptcy filing. BLG 3 addresses the presentation of reorganization items.

2.10 **Disclosure considerations (pre-bankruptcy)**

ASC 275, *Risks and Uncertainties*, requires entities to disclose information about risks and uncertainties in their financial statements in the following areas:

- Nature of operations
- Use of estimates in the preparation of financial statements
- Certain significant estimates
- Current vulnerability resulting from certain concentrations

An estimate should be disclosed when known information available before the financial statements are issued (or are available to be issued for private companies) indicates that both of the following criteria are met:

- It is at least reasonably possible that the estimate of the effect on the financial statements of a condition, situation, or set of circumstances that existed at the date of the financial statements will change in the near term due to one or more future confirming events.
- The effect of the change would be material to the financial statements.

Reporting entities considering a bankruptcy filing face unique challenges from an operational and financial perspective. Entities should consider disclosure of these difficulties and the potential for a bankruptcy filing under ASC 275. This could include the state of the operations and any restructuring or exit activities initiated to increase liquidity. Also, reporting entities should disclose their vulnerability to and impact of macroeconomic factors or industry challenges. SEC registrants may have additional disclosure requirements, some of which are highlighted in BLG 2.10.1 through BLG 2.10.4.
2.10.1 Going concern assessment (pre-bankruptcy)

For each annual and interim reporting period, a reporting entity should evaluate whether there are conditions that give rise to substantial doubt about the reporting entity’s ability to continue as a going concern within one year from the financial statement issuance date, and if so, provide related disclosures. Accordingly, SEC registrants with interim reporting requirements should assess going concern uncertainties quarterly. Nonpublic entities should assess going concern uncertainties annually, or more frequently if they issue interim financial statements that are prepared under US GAAP.

Conditions that give rise to substantial doubt ordinarily relate to a reporting entity’s ability to meet its obligations as they become due. Management’s assessment should be based on the relevant conditions that are “known and reasonably knowable” at the issuance date, rather than at the balance sheet date. ASC 205-40, Going Concern, requires management to consider information about the following conditions, among others, as of the financial statement issuance date:

- The reporting entity’s current financial condition including its current liquid resources
- Conditional and unconditional obligations due or anticipated in the next year
- Funds necessary to maintain operations considering the reporting entity’s current financial condition, obligations, and other expected cash flows in the next year
- Other conditions that could adversely affect the reporting entity’s ability to meet its obligations in the next year

If conditions give rise to substantial doubt in the initial assessment, management should consider its plans and their mitigating impact. In doing so, management should assess whether its plans to mitigate the adverse conditions, when implemented, will alleviate substantial doubt. Disclosures are required if conditions give rise to substantial doubt, even if the substantial doubt is alleviated by management’s plans. Whether or not substantial doubt is alleviated, footnote disclosures should focus on pertinent information about significant conditions that are specific to going concern uncertainties, management’s evaluation of those conditions, and management’s plans. SEC registrants may use Management’s Discussion and Analysis to complement and expand upon footnote disclosures by providing additional context about the potential causes and effects of going concern uncertainties.

See FSP 24.5 for discussion of a reporting entity’s required going concern assessment and the related disclosures.

2.10.2 Asset impairment disclosures (pre-bankruptcy)

Disclosure of the potential for material write-downs of assets, including deferred tax asset valuation allowances, is of importance to investors even if an impairment has not been recognized. Additionally, more transparent disclosure is often required related to both the methods and assumptions used in impairment testing. For example, the SEC staff has requested that registrants consider the following disclosures:

- “Foreshadowing” disclosures in periods prior to impairment
Accounting and reporting considerations prior to entering bankruptcy

- The facts and circumstances that resulted in an impairment, as well as information about the existence of triggering events. If such disclosures are not provided, the timing of the reporting entity's impairment charge may be questioned.

- Whether the reporting entity's expectations for future earnings or cash-flow projections have changed, and the factors that may have changed and consequently resulted in a goodwill balance that could not be supported. Disclosure of what the impairment did not impact—such as cash flows or debt covenants—is not as useful as disclosure about what was impacted.

- Where no current impairment exists, the occurrence of future events or deteriorating conditions that could result in a future impairment, as well as a sensitivity analysis to show the impact that changes in assumptions could have on the outcome of the impairment test.

- The reporting units at which goodwill is tested for impairment and the methodologies used to determine the fair values of the reporting units (as well as a reconciliation of the total fair value of all reporting units to the total market capitalization), including sufficient information to allow a reader to understand why management selected these methods.

- Reporting units that are at risk for failing step one of the goodwill impairment test, including the carrying amounts and sensitivity analyses of the reporting units' fair values.

This type of information provides detailed disclosures about the methods and assumptions used in the asset impairment testing and any indicators that an impairment charge may be required in the future.

### 2.10.3 Restructuring and exit activity disclosures (pre-bankruptcy)

Management often undertakes restructuring and exit activities to increase liquidity and profitability in the period prior to a bankruptcy filing. SEC staff comments about registrants' disclosures related to these activities typically fall into the following areas:

- Identify the specific facts and circumstances related to the restructuring and exit activities.

- Include required disclosures under the applicable US GAAP.

- Provide separate rollforwards of activity for each restructuring plan.

- Explain the basis for any significant adjustments to the recorded reserves (as this could indicate the initial accounting is incorrect).

- Include the impact of restructuring activities in the liquidity section of MD&A.

- Provide support for the timing of recording restructuring or impairment charges (a foreshadowing disclosure is a helpful “trail” in situations where restructuring or impairment is expected in the near future).

### 2.10.4 Liquidity disclosures (pre-bankruptcy)

Additional disclosures in MD&A related to liquidity may be necessary when a public entity contemplates a bankruptcy filing. Further, users of the financial statements will need to understand management's plans to increase liquidity and remain a going concern. Thus, disclosures in the
Accounting and reporting considerations prior to entering bankruptcy

Financial statements will help users assess management's plans and make investment decisions. The disclosures are especially important if the reporting entity continues to incur significant operating losses or cash outflows from operations and where bankruptcy appears to be possible because of liquidity constraints and the inability to raise additional capital.

SEC staff comment letters tend to be focused on debt agreements and a reporting entity’s compliance with its outstanding debt covenants and potential default conditions. Comment letters include requests for additional disclosures in the following areas: (1) the terms of the most restrictive debt covenants; (2) any stated events or defaults that would permit the lenders to accelerate the debt if not cured within applicable grace periods, including the failure to make payments under the agreement; (3) a tabular presentation of any significant required ratios as well as actual ratios as of the reporting date; and (4) the computations used to arrive at actual ratios and any corresponding reconciliations to US GAAP amounts, if necessary.

Liquidity disclosures should also be considered where a reporting entity has a committed credit facility. These disclosures would include an evaluation of whether there are limitations on the reporting entity’s ability to borrow the full amount and whether the limitations may become an issue in the near term.

Another area of frequent SEC staff comment is the adequacy of disclosures related to a reporting entity’s foreign investments. As described in BLG 2.7.1, a looming bankruptcy proceeding may put pressure on a reporting entity’s ability to continue to maintain its indefinite reinvestment assertion for the outside basis difference attributable to its foreign subsidiaries resulting in the need to recognize current and deferred income taxes.

Other potential disclosures include future plans for raising capital, any anticipated issues in accessing capital markets, and how the business would be impacted if capital cannot be raised.

2.11 Bankruptcy as a subsequent event

If a reporting entity files for bankruptcy, the actual filing of the bankruptcy petition may occur during the period after a balance sheet date, but prior to the issuance of the financial statements. In these instances, the filing should be treated as a nonrecognized subsequent event under the guidance of ASC 855, Subsequent Events. This guidance requires disclosure of the filing itself and relevant details associated with the filing. The financial statements as of the period-end prior to filing would not reflect any accounting under ASC 852-10, nor would they include the debtor-in-possession label as discussed in BLG 3.2.
3.1 Accounting and reporting during bankruptcy: Chapter overview

Once a reporting entity has filed a petition for bankruptcy under Chapter 11 of the Bankruptcy Code, its accounting and financial reporting fall under the scope of ASC 852-10, Reorganizations, which incorporated the guidance in AICPA Statement of Position 90-7, Financial Reporting by Entities in Reorganization Under the Bankruptcy Code (SOP 90-7). SOP 90-7 was first published in 1990, and through its incorporation into the ASC, its guidance continues to serve as the foundation for accounting and reporting during bankruptcy. ASC 852-10 also includes illustrative financial statements and a glossary of terms.

In this chapter, the primary focus is the accounting and financial reporting for a reporting entity involved in a Chapter 11 bankruptcy proceeding. ASC 852-10 applies only to Chapter 11 proceedings, and it excludes governmental organizations and entities that are in liquidation under Chapter 7 of the Bankruptcy Code or for other reasons. See BLG 6 for considerations around the liquidation basis of accounting.

A key objective of the financial reporting by entities in bankruptcy is to reflect the financial evolution of the bankruptcy proceedings. The guidance requires that transactions and events directly associated with the reorganization be distinguished from the ongoing operations of the business. In addition, ASC 852-10 provides for changes in the accounting and presentation of significant items on the balance sheet, particularly liabilities. This chapter covers the methods for distinguishing the activities of the bankruptcy process and how those various activities are presented in the financial statements.

3.2 Financial reporting during bankruptcy under ASC 852-10

A reporting entity’s financial statements while reporting under ASC 852-10 are in most ways presented similar to those for the period prior to the filing of the petition. The reporting entity will continue to present a balance sheet and statements of operations, cash flows, and changes in stockholders’ equity, as well as notes to the financial statements, after filing the petition. An important distinguishing feature, however, is the labeling of the financial statements. A debtor-in-possession title should clearly label each financial statement. See BLG 7.2 for examples of common disclosures by a reporting entity during periods of financial distress leading up to and while in bankruptcy. Also, BLG 7.3 includes examples of additional disclosures required in the period between the filing of the petition and the reporting entity’s emergence from bankruptcy.

Critical points in the accounting and financial reporting for a reporting entity in bankruptcy are found within ASC 852-10-45-1 and ASC 852-10-45-2, which state:

ASC 852-10-45-1

Entering a reorganization proceeding, although a significant event, does not ordinarily affect or change the application of generally accepted accounting principles (GAAP) followed by the entity in the preparation of its financial statements. However, the needs of financial statement users change, and thus changes in the reporting practices previously followed by the entity are necessary.
Accounting and reporting during bankruptcy

ASC 852-10-45-2

For the purpose of presenting an entity's financial evolution during a Chapter 11 reorganization (see paragraph 852-10-1-1), the financial statements for periods including and after filing the Chapter 11 petition shall distinguish transactions and events that are directly associated with the reorganization from the ongoing operations of the business.

The guidance in ASC 852-10-45-1 provides the general concept that financial reporting during a bankruptcy proceeding does not necessarily affect the accounting for most items on the balance sheet and in the income statement. In most cases, other GAAP would continue to apply in the recognition and measurement of assets and liabilities as if a reporting entity was not involved in a bankruptcy proceeding. For example, the literature applicable to the various accounting matters discussed in BLG 2, such as asset impairments, other asset valuation matters, and income tax considerations, would generally still apply after a bankruptcy filing. However, because a reporting entity in bankruptcy is clearly in circumstances different from those in periods before the filing of the petition, some changes in the financial statements are needed to reflect the unique aspects of the bankruptcy proceeding.

The most significant impact of ASC 852-10 on the reporting of balance sheet items involves the classification and presentation of liabilities of a reporting entity in reorganization. These are discussed in BLG 3.3.

Question BLG 3-1

How should the filing of a voluntary petition for bankruptcy protection under Chapter 11 of the Bankruptcy Code on January 30 impact Company A’s calendar year-end financial statements which have not been issued?

PwC response

The application of the accounting requirements of ASC 852-10 begins upon the filing of the bankruptcy petition for reorganization. As such, Company A would not report the calendar year-end financial statements under ASC 852-10. In addition, the financial statements should not be labeled as “debtor-in-possession” as to do so would suggest that the bankruptcy accounting guidance had been adopted for the financial statements presented. Even though substantial bankruptcy-related costs are usually incurred prior to filing for bankruptcy, “Reorganization items, net” would typically not be reflected as a caption in the income statement for the fiscal period(s) included in the financial statements prior to the petition date.

The filing for bankruptcy and its impact on the financial statements would usually be disclosed as a subsequent event in the year-end financial statements.

3.3 Presentation of liabilities under ASC 852-10 during bankruptcy

Liabilities under ASC 852-10 are separated into obligations that were incurred prior to the filing of the bankruptcy petition—prepetition liabilities—and those incurred after the filing—postpetition liabilities. Prepetition liabilities are further segregated into those that are subject to compromise and those that are not subject to compromise, as explained in ASC 852-10-45-4.
**ASC 852-10-45-4**

The balance sheet of an entity in Chapter 11 shall distinguish prepetition liabilities subject to compromise from those that are not (such as fully secured liabilities that are expected not to be compromised) and postpetition liabilities. Liabilities that may be affected by the plan shall be reported at the amounts expected to be allowed, even if they may be settled for lesser amounts. If there is uncertainty about whether a secured claim is undersecured, or will be impaired under the plan of reorganization, the entire amount of the claim shall be included with prepetition claims subject to compromise; such a claim shall not be reclassified unless it is subsequently determined that the claim is not subject to compromise.

Figure BLG 3-1 illustrates a sample balance sheet for a reporting entity that is in bankruptcy.

**Figure BLG 3-1**  
Sample balance sheet under ASC 852-10

| J&B Industries |  
| --- | --- |
| (Debtor-in-possession)¹ |  
| Consolidated balance sheet | (in millions, except per share amounts) |  
|  

<table>
<thead>
<tr>
<th>Assets</th>
<th>December 31, 202X</th>
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<tbody>
<tr>
<td>Current assets:</td>
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<td>Cash and cash equivalents</td>
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<td>Accounts receivable</td>
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<td>Inventory</td>
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<td>Total current assets</td>
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<td>Property, plant, and equipment, net</td>
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<td>Intangible asset, net</td>
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<td>Goodwill</td>
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<td>Total assets</td>
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<td>Liabilities and stockholders’ deficit</td>
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<td>Current liabilities:</td>
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<td>Notes payable</td>
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<td>Debtor-in-possession financing</td>
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<td>Accounts payable</td>
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<td>Total current liabilities</td>
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<td>Liabilities subject to compromise²</td>
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</tr>
<tr>
<td>Total liabilities</td>
<td>6,535</td>
</tr>
</tbody>
</table>

¹ Debtor-in-possession  
² Excludes the estimated fair value of contingent liabilities arising from operations.
Stockholders' deficit

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Common stock</td>
<td>150</td>
</tr>
<tr>
<td>Additional paid-in capital</td>
<td>800</td>
</tr>
<tr>
<td>Accumulated deficit</td>
<td>(3,935)</td>
</tr>
<tr>
<td><strong>Total stockholders' deficit</strong></td>
<td>(2,985)</td>
</tr>
<tr>
<td><strong>Total liabilities and stockholders' deficit</strong></td>
<td>$ 3,550</td>
</tr>
</tbody>
</table>

1. All financial statements should be labeled as “Debtor-in-possession” until the reporting entity’s emergence from bankruptcy.
2. Liabilities subject to compromise are segregated and presented separate from current liabilities.

Liabilities subject to compromise are prepetition obligations that are not fully secured and that have at least a possibility of not being repaid at the full claim amount. These liabilities, which generally make up the majority of liabilities in a bankruptcy filing, can include any type of obligation of the reporting entity, such as trade payables, contract obligations, lease liabilities, or unsecured debt. Other prepetition obligations may be classified outside of liabilities subject to compromise when they can be demonstrated to be fully secured. The determination of which liabilities are subject to compromise is initially made at the date of the bankruptcy filing based on whether the liability is adequately secured. If unsecured, or if there is doubt as to the adequacy of the value of security related to a given liability, the entire liability should be included in liabilities subject to compromise. For example, if a debtor's $100 liability to a vendor is secured by a specific asset with a fair value of $80 as of the petition filing date, the entire amount of the liability—not just the undersecured $20 portion—would be included as a liability subject to compromise.

Liabilities subject to compromise are presented in aggregate as one line on the balance sheet and are classified outside of current liabilities but included in total liabilities. Under the Bankruptcy Code, most prepetition claims are not allowed to be paid until after the reorganization plan has been confirmed, the timing of which in most cases cannot be predicted. The Discussion of Conclusions in SOP 90-7, which was not carried forward in the Codification, implied that the liabilities subject to compromise should be presented outside of current liabilities since it often takes more than a year for a bankruptcy proceeding to run its course. Furthermore, the principal categories and amounts of liabilities subject to compromise should be disclosed in the notes to the financial statements.

As stated in ASC 852-10-45-5, liabilities subject to compromise, including claims that become known after the bankruptcy petition is filed, should be reported on the basis of the expected amount of the total allowed claims, even if the claims will be settled at lesser amounts (in other words, the allowed claims balance should not be reported at “cents on the dollar” amounts).
Prepetition liabilities, including claims that become known after a petition is filed, shall be reported on the basis of the expected amount of the allowed claims in accordance with Subtopic 450-20, as opposed to the amounts for which those allowed claims may be settled. Once these claims satisfy the accrual provisions of that Subtopic, they shall be recorded in the accounts in accordance with this paragraph. Paragraph 852-10-50-2 notes that claims not subject to reasonable estimation are required to be disclosed in the notes to financial statements.

**Question BLG 3-2**

**What is an allowed claim?**

**PwC response**

An allowed claim is one that begins as either (1) included in the debtor’s listing of liabilities filed with the Court or (2) submitted by a creditor to the Court and not objected to by the debtor. Once the debtor accepts a claim, or decides not to object to a claim submitted by a creditor, a claim is generally considered an allowed claim, even if the Court has not explicitly approved the claim.

In some instances, the various parties may not agree on the amount of an allowed claim, and its value might be resolved only by a ruling of the Court. The Court will determine, often by using formulas, the amount of allowed claims for rejected contracts such as leases. Once an amount has been established and approved by the Court, the claim becomes an allowed claim.

The recognition and measurement of allowed claims should follow the model described in ASC 450-20, *Loss Contingencies*, and thus should reflect the reporting entity’s best estimate of its total allowed claims. Accordingly, a reporting entity’s liabilities subject to compromise balance will generally differ from the prepetition measurement of the underlying liabilities which make up this balance. Claims not subject to reasonable estimation should be disclosed in the notes to the financial statements, which may include unliquidated, contingent, or disputed claims filed by creditors. In some cases, such as rejected leases or other contracts, the allowed claim amount might be determined by the Court or through negotiations with the Court. The expected allowed claim amounts may in fact change as the bankruptcy proceedings run their course (e.g., based on actions of the Court) and new or better information becomes available. As the estimates change, the amounts recorded should be updated in the subsequent financial statements. Figure BLG 3-2 illustrates disclosure of a bankrupt entity’s liabilities subject to compromise.
Liabilities subject to compromise represent liabilities incurred prior to the commencement of the bankruptcy proceedings which may be affected by the Chapter 11 process. These amounts represent the reporting entity’s allowed claims and its best estimate of claims expected to be allowed which will be resolved as part of the bankruptcy proceedings.

Liabilities subject to compromise consist of the following:

<table>
<thead>
<tr>
<th></th>
<th>Year ended December 31, 20X1</th>
</tr>
</thead>
<tbody>
<tr>
<td>Debt</td>
<td>$3,000</td>
</tr>
<tr>
<td>Accounts payable</td>
<td>500</td>
</tr>
<tr>
<td>Pension obligation</td>
<td>1,000</td>
</tr>
<tr>
<td>Other liabilities</td>
<td>325</td>
</tr>
<tr>
<td><strong>Total liabilities subject to compromise</strong></td>
<td><strong>$4,825</strong></td>
</tr>
</tbody>
</table>

1 The sample disclosure illustrates an abridged version of what a reporting entity in bankruptcy would disclose for its liabilities subject to compromise. The sample is not meant to be an all-inclusive representation of what information would need to be disclosed. A reporting entity should consider the specific facts and circumstances surrounding its liabilities subject to compromise and disclose accordingly.

Under bankruptcy accounting, liabilities subject to compromise are presented at their expected amount of the total allowed claim. As a result, in most cases, liabilities are initially presented at amounts higher than the expected settlement amount. Only later, as the claims are addressed by the Court or the reorganization plan is confirmed, are they adjusted to their settlement amounts. This concept is critical in preparing the financial statements of a reporting entity in bankruptcy.

For example, assume a reporting entity files for bankruptcy on June 15. At the time of filing, it owes one of its unsecured creditors $100 for a prepetition trade payable. In preparing its June 30 financial statements, the reporting entity expects that this liability will be an allowed claim in the amount of $100. Based on discussions with its bankruptcy advisors, the reporting entity believes that its unsecured claims will eventually be paid in the “20 cents on the dollar” range. Given these facts, the reporting entity will measure this claim in its June 30 balance sheet within liabilities subject to compromise at its expected allowed claim amount of $100. As mentioned above, expected settlement amounts are not considered for financial reporting purposes until the reorganization plan is confirmed by the Court. The adjustments that take place after confirmation are discussed in BLG 4.4.2.

If the allowed claim is later adjusted by the Court on December 15 to a revised allowed claim amount of $70, the reporting entity would present the allowed claim at $70 in its December 31 balance sheet. The $30 adjustment would be recorded as a reorganization item in the income statement for the period ended December 31. Reorganization items are discussed later in this chapter.
Figure BLG 3-3 illustrates the changes that a prepetition liability may encounter as the bankruptcy proceeding evolves.

**Figure BLG 3-3**  
Liabilities subject to compromise during a typical bankruptcy proceeding

<table>
<thead>
<tr>
<th>Liabilities subject to compromise</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Period prior to filing for bankruptcy</strong></td>
<td>Account for liabilities as set forth under GAAP for entities not in bankruptcy</td>
</tr>
</tbody>
</table>
| **Upon filing the petition for bankruptcy** | Record liabilities subject to compromise at expected amount of allowed claim under ASC 852-10-45-5  
Consider recognizing a change in carrying amount on the petition filing date  
The change in carrying amount may be reported as a reorganization item or within another financial statement line item in the income statement for the current period depending on the direct cause of the change (BLG 3.10.1) |
| **Reporting during the bankruptcy proceedings** | Adjust the expected amount of an allowed claim\(^1\) as it changes due to new information or developments through the bankruptcy process  
Recognize change in carrying amount as a reorganization item |

\(^1\) The expected amount of the allowed claim may differ from the expected settlement amount.

Obligations (or liabilities) not subject to compromise are prepetition obligations that are fully secured and are expected to be settled in full. These liabilities are recorded under the GAAP that would apply outside of bankruptcy and presented in the financial statements as they were before the filing of the petition.

ASC 852-40-45-7 addresses liabilities that may change classification as the bankruptcy evolves.

**ASC 852-10-45-7**

Paragraph 852-10-45-4 addresses the separation of liabilities subject to compromise from those that are not. Circumstances arising during reorganization proceedings may require a change in the classification of liabilities between those subject to compromise and those not subject to compromise. Liabilities not subject to compromise shall be further segregated into current and noncurrent classifications if the entity presents a classified balance sheet.

Fully-secured liabilities that may become impaired in the reorganization plan should be included as liabilities subject to compromise. For example, if the asset that is securing a liability diminishes in value such that the liability is no longer fully secured, it may be appropriate to reclassify that liability to a liability subject to compromise. On the other hand, some claims may be finalized early in the bankruptcy process and should be reclassified from liabilities subject to compromise. The Court often approves some level of payment for prepetition claims for critical vendors of the debtor early in the proceedings so that the debtor can continue to operate its business. When the character of a claim changes such that some or all of the claim will be paid, it may be appropriate to reclassify the portion
of the claim approved for payment out of liabilities subject to compromise since, by definition, the claim is no longer subject to compromise. For example, if at an interim hearing, $40 of a debtor's $100 liability to a vendor is approved for payment, $40 of the liability should be reclassified from liabilities subject to compromise. The remainder would continue to be classified as subject to compromise. This specific change is supported by the activity of the Court and is not based on management intent.

In BLG 1, the legal concept of impairment of claims was discussed. Regardless of whether creditor claims are presented in the reorganization plan as impaired or unimpaired, the classification on the balance sheet is generally determined by whether the claim is a pre or postpetition liability and whether it is subject to compromise based on the extent of any security.

Although the definitions of impairment and subject to compromise are similar, the classification of a claim as impaired or unimpacted in a reorganization plan reflects only the debtor's intent until the plan is confirmed. The eventual determination of how these claims will be resolved is made when the plan is confirmed by the Court. As such, the debtor's treatment of a liability in the reorganization plan does not necessarily reflect whether the claim should be classified as subject to compromise. In most cases, claims that are not fully secured have an element of uncertainty regarding whether they will ultimately be confirmed as unimpaired. As a result, these claims would usually be presented in the financial statements as liabilities subject to compromise and would remain in this category until the plan is confirmed or the Court otherwise approves their payment during the proceedings.

**Question BLG 3-3**

How should a reporting entity that is entering into bankruptcy report its liability for product warranties?

**PwC response**

Although ASC 852-10-45-4 may indicate that only warranty claims “known” at the bar date, which is the deadline by which creditors have to notify the Court of all claims, should be reflected as liabilities, we believe the guidance in ASC 852-10-45-1 provides the overriding principle that a bankruptcy filing does not ordinarily affect or change a reporting entity’s application of GAAP in the preparation of its financial statements. Accordingly, in the case of product warranty liabilities, if the reporting entity intends to honor prepetition warranty claims that arise after the bar date, we believe the reporting entity should record the amount computed in accordance with ASC 450, Contingencies, even though the known claims at the bar date may be a lower amount.

**Question BLG 3-4**

How should a reporting entity in bankruptcy account for a fee incurred in connection with terminating certain interest rate swaps executed with the counterparty prior to filing for bankruptcy protection?

**PwC response**

The reporting entity should present the termination fee at the expected amount of the total allowed claim upon filing for bankruptcy. The amount should be adjusted as necessary during the proceedings if the estimate of the allowed claim changes (e.g., due to a Court-approved decision). Credit-related adjustments to the liability that might be necessary under other applicable guidance would no longer be made.
Question BLG 3-5
Is it appropriate for a reporting entity in bankruptcy to reclassify unsecured and undersecured liabilities from liabilities subject to compromise if its reorganization plan anticipates that the liabilities will not be impaired (meaning the plan calls for these claims to be paid in full upon confirmation)?

PwC response
Until the reorganization plan has been confirmed by the Court, the unsecured and undersecured liabilities should remain classified as subject to compromise. For example, even if a reporting entity has a high degree of certainty that unsecured and undersecured claims will be paid in full, and the reporting entity includes those claims as unimpaired in the reorganization plan, the claims should still be reflected as liabilities subject to compromise. They would remain in this category until their payment status is finalized through the proceedings, in accordance with ASC 852-10-45-17 and ASC 852-10-45-18.

Example BLG 3-1 illustrates the accounting treatment for Court-approved payments of certain prepetition liabilities while a reporting entity is in bankruptcy.

EXAMPLE BLG 3-1
Treatment of Court-approved payments

During the initial hearings of Company T’s Chapter 11 bankruptcy on December 20, 202X, the Court approved certain payments for some of the reporting entity’s key suppliers. These suppliers provide key materials and services that the reporting entity needs to operate its business during the proceedings to preserve the value of the estate. The Court approved payments of 75% of the prepetition liabilities for these key suppliers with payments to be made on January 10 of the following year. The remaining 25% of the suppliers’ claims will continue to be represented as allowed claims against the reporting entity.

How should Company T present these liabilities in its December 31, 202X balance sheet?

Analysis

The portion of the claims approved for payment by the Court should be reclassified from liabilities subject to compromise on the balance sheet as of December 31, 202X and presented with other postpetition liabilities. The remaining 25% of the suppliers’ claims should remain within liabilities subject to compromise at the expected amount of the allowed claim.

3.4 Postpetition and other liabilities during bankruptcy

Liabilities incurred in the postpetition period are presented separately and classified as they ordinarily would be under other GAAP. As mentioned in BLG 1, these liabilities are generally expected to be paid by the debtor throughout the bankruptcy process.

The reporting entity should continue to recognize all recurring liabilities required by GAAP, such as pensions and other employee benefits, asset retirement obligations, environmental liabilities, insurance reserves, and other liabilities as set forth under the applicable literature. If the
arrangements that give rise to these liabilities are acted on by the Court, the liabilities would be adjusted based on the nature of the changes to the arrangements. Classification of these liabilities as liabilities subject to compromise would be determined based on the factors discussed above.

### 3.5 Prepetition debt and related debt issue costs during bankruptcy

ASC 852-10-45-6 discusses the accounting for debt and debt issue costs when the debt becomes an allowed claim.

**ASC 852-10-45-6**

Debt discounts or premiums as well as debt issue costs shall be viewed as valuations of the related debt. When the debt has become an allowed claim and the allowed claim differs from the net carrying amount of the debt, the recorded amount shall be adjusted to the amount of the allowed claim (thereby adjusting existing discounts or premiums, and deferred issue costs to the extent necessary to report the debt at this allowed amount). The gain or loss resulting from the entries to record the adjustment shall be classified as reorganization items, as discussed in paragraph 852-10-45-9. Premiums and discounts as well as debt issuance cost on debts that are not subject to compromise, such as fully secured claims, shall not be adjusted.

The treatment of debt and debt issue costs depends on whether the related debt is secured or unsecured (or undersecured). As discussed in ASC 835-30-45-1A, as it relates to term debt, a debt discount or premium, as well as debt issuance costs, should be reported as an adjustment to the carrying amount of the related debt. However, as discussed in ASC 835-30-S45-1, costs associated with entering into a revolving line of credit or revolving debt arrangement meet the definition of an asset and should be recorded as such on the balance sheet. See FG 1.2 for discussion of the accounting for debt discounts, premiums, as well as debt issue costs related to term debt. See FG 1.3 for discussion of the accounting for debt issue costs related to line of credit arrangements.

Debt discounts, premiums, and debt issue costs on borrowings that are subject to compromise (e.g., unsecured or undersecured debt) that were not adjusted prior to the bankruptcy filing should be viewed as part of the valuation of prepetition debt. For debt that is subject to compromise, these items would no longer be amortized and instead be reflected as an adjustment to the associated debt’s carrying amount upon filing for bankruptcy, as ASC 852-10-45-11 specifically limits the recognition of interest expense during a bankruptcy proceeding to only amounts that will be paid during the bankruptcy proceeding or that are probable of becoming allowed claims. If the allowed claim amount for the debt differs from its net carrying amount after reclassification, the net carrying amount should be adjusted to the amount of the allowed claim.

For example, if the reporting entity has unsecured debt with an outstanding principal of $100 and unamortized debt issue costs of $5, the net carrying amount for this borrowing would be $95. If the allowed claim amount for this borrowing is determined by the Court to be $100, the reporting entity would include $5 in reorganization expense (as opposed to interest expense) to adjust the net carrying amount of the debt to its allowed claim amount, thus effectively writing off the debt issue costs.
As with other liabilities subject to compromise discussed earlier, if the Court later adjusted the allowed claim amount, the reporting entity would again adjust the carrying amount of its debt. The gain or loss resulting from the adjustment should be classified as a reorganization item in the income statement.

Some diversity in practice exists as to when a reporting entity should adjust the net carrying amount of its debt which is subject to compromise to the amount of the allowed claim. ASC 852-10-45-6 states that such adjustment to the debt's carrying amount should take place when the claim becomes an allowed claim. This threshold might not be met until some time has passed in the bankruptcy proceedings because a claim is not always considered an allowed claim on the bankruptcy filing date. This would suggest that these items should be left unchanged until the claim becomes an allowed claim. Alternatively, ASC 852-10-45-5 states that liabilities subject to compromise should be recorded at the expected allowed claim amount. The debtor would subsequently adjust the recorded amount for the claim if the Court allows a different amount. With respect to debt subject to compromise, both approaches would appear to be reasonable. However, a reporting entity should apply a consistent approach to each of its borrowings which is subject to compromise.

Debt discounts, premiums, and debt issuance costs on borrowings that are not subject to compromise, such as fully secured debt, should not be adjusted upon filing for bankruptcy.

Figure BLG 3-4 illustrates the typical accounting for debt and debt issuance costs in the periods prior to and during the bankruptcy proceedings.

**Figure BLG 3-4**
Accounting for debt and debt issuance costs during a typical bankruptcy proceeding

<table>
<thead>
<tr>
<th>Period prior to filing for bankruptcy</th>
<th>Debt—subject to compromise and related costs, discounts and premiums</th>
<th>Debt—not subject to compromise (i.e., fully secured) and related costs, discounts and premiums</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Account for as set forth under GAAP for entities not in bankruptcy</td>
<td>Account for as set forth under GAAP for entities not in bankruptcy</td>
</tr>
<tr>
<td></td>
<td>Consider expected term of the debt for amortization period of debt issuance costs, especially if covenant violations are present (See FG 1.2.3)</td>
<td>Consider expected term of the debt for amortization period of debt issuance costs, especially if covenant violations are present (See FG 1.2.3)</td>
</tr>
<tr>
<td></td>
<td>Consider classification of debt and related debt issuance costs, discounts, and premiums based on the term of the debt and compliance with covenants</td>
<td>Consider classification of debt and related debt issuance costs, discounts, and premiums based on the term of the debt and compliance with covenants</td>
</tr>
<tr>
<td>Upon filing the petition for bankruptcy</td>
<td>Reclassify debt discounts, premiums, and debt issue costs, if any, into the carrying amount of the debt</td>
<td>Account for as set forth under GAAP for entities not in bankruptcy</td>
</tr>
<tr>
<td></td>
<td>Adjust carrying amount to expected allowed claim as a reorganization item, if expected allowed claim is different than carrying amount, (alternatively, adjust to allowed claim amount when the claim becomes an allowed claim)</td>
<td></td>
</tr>
</tbody>
</table>
Debt—subject to compromise and related costs, discounts and premiums | Debt—not subject to compromise (i.e., fully secured) and related costs, discounts and premiums
---|---
**Reporting during the bankruptcy proceedings** | **Adjust to allowed claim amount, if necessary** | **Continue to account for as set forth under GAAP for entities not in bankruptcy unless debt becomes subject to compromise**
Recognize changes in carrying amount as a reorganization item

ASC 852-10-45-8 addresses debt classification for a reporting entity in bankruptcy.

**ASC 852-10-45-8**
Section 470-10-45 requires current liabilities classification in a classified balance sheet for long-term liabilities that, by their terms, are due on demand or will be due on demand within one year, or the operating cycle, if longer. This classification requirement also applies to long-term liabilities that are or will be callable by the creditor because of a violation of a provision of the debt agreement. The automatic stay provisions of Chapter 11 make it unnecessary to reclassify prepetition long-term liabilities even though prepetition creditors might demand payment or there is a violation of a covenant in the debt agreement.

Example BLG 3-2 illustrates how secured debt (i.e., not subject to compromise) should be classified on the balance sheet when the debt is callable by the creditor due to an event of default.

**EXAMPLE BLG 3-2**
Balance sheet classification of debt not subject to compromise but that is callable by the creditor due to an event of default

A reporting entity in bankruptcy has senior debt that will not be impaired in its plan of reorganization (and thus not subject to compromise). However, the senior debt agreement contains a cross-default provision that was triggered when the reporting entity filed for bankruptcy and stopped making payments on its other debt obligations which are subject to compromise. Although they have the right to do so because of the event of default, the senior debt holders have not called the senior debt. Additionally, the senior debt agreement does not contain a grace period during which the reporting entity may cure the violation.

Should the senior debt be classified as a current or noncurrent liability?

**Analysis**
ASC 852 states that “liabilities not subject to compromise should be further segregated into current and non-current classifications if the reporting entity presents a classified balance sheet.” Consistent with ASC 852-10-45-1, unless the guidance specifically provides an exception, “normal GAAP” would continue to apply while a reporting entity is in bankruptcy.

Therefore, because the senior debt is not subject to compromise, its classification (along with its recognition and measurement) should continue to follow “normal GAAP.” Under ASC 470, the senior debt would be classified as current as neither of the conditions in ASC 470-10-45-11 were met (i.e., the
debt holders have not waived or lost the right to demand repayment for more than one operating cycle, and the debt does not provide a grace period during which it is probable that the violation will be cured). In this case, the creditor has neither waved nor subsequently lost the right to demand repayment; nor did the long-term obligation contain a grace period within which the debtor could cure the violation. It would be difficult for management to assert that the creditor has lost the right to demand repayment for more than one year solely because of the bankruptcy as the timing of the proceedings are outside the control of management.

### 3.6 New debt issuance costs and professional fees during bankruptcy

Entities may incur professional fees in conjunction with obtaining debtor-in-possession financing while in bankruptcy. Questions often arise as to whether such fees should be expensed as incurred as reorganization items in accordance with ASC 852-10-45-10 or deferred and amortized over the life of the debt as accounted for outside bankruptcy. ASC 852-10-45-10 provides guidance on the treatment of professional fees.

ASC 852-10-45-10

It is not appropriate to defer professional fees and similar types of expenditures until the plan is confirmed and then reduce gain from debt discharge to the extent of the previously deferred expenses. It is also not appropriate to accrue professional fees and similar types of expenditures upon the filing of the Chapter 11 petition. Rather, because professional fees and similar types of expenditures directly relating to the Chapter 11 proceeding do not result in assets or liabilities, they shall be expensed as incurred and reported as reorganization items.

In making such a determination, the reporting entity should consider whether the related debt will be paid in full prior to emergence from bankruptcy or remain outstanding and continue after emergence. In many cases, the costs related to debtor-in-possession financing for debt that will be paid in full prior to emergence from bankruptcy are expensed as incurred as reorganization items. We are aware of an alternative approach to defer and amortize these costs over the expected term of the debtor-in-possession financing. As the contractual term of the financing is usually based on the time that that the debtor is in bankruptcy, reporting entities should update the expected term each reporting period. Under this approach, amortization of the deferred debt issuance costs is recorded as interest expense, which is presented outside of reorganization items.

Professional fees that become payable upon emergence from bankruptcy, often referred to as contingent fees or success fees, should be expensed upon emergence and recorded within reorganization items. For a reporting entity qualifying for fresh start reporting, such costs would be recognized by the predecessor entity at emergence. Professional fees, with perhaps the exception of certain debt issue costs as mentioned above, should not be capitalized by a reporting entity in bankruptcy.
3.7 Goodwill and indefinite-lived intangibles during bankruptcy

While applying the bankruptcy-specific guidance found in ASC 852-10, the impairment guidance under ASC 350, Intangibles—Goodwill and Other, should still be considered for goodwill and indefinite-lived intangible assets. It is generally not appropriate to impair intangible assets, including goodwill, on the date that a reporting entity files for Chapter 11, unless the application of the relevant accounting guidance results in an impairment charge. That is, recognition and measurement of an impairment loss for these assets would depend on the facts and circumstances of each reporting entity and would follow the same guidance used by entities not in bankruptcy. However, as discussed in BLG 2.2.1 with respect to goodwill and BLG 2.2.2 with respect to indefinite-lived intangible assets, prior to filing for bankruptcy, the reporting entity should carefully consider whether a triggering event for impairment testing has occurred. In addition, the bankruptcy filing usually warrants additional consideration of whether a need for impairment testing has been triggered.

3.8 Leases under ASC 842 during bankruptcy

During a bankruptcy proceeding, a debtor's existing lease agreements will be affirmed, amended, or rejected. Until the Court approves an action, the debtor should continue to amortize right-of-use assets and consider impairment and/or revisions to the assets’ useful lives in accordance with ASC 360-10. Lease liabilities should continue to be recognized until rejected leases are approved by the Court. Leases affirmed in the bankruptcy process without modification should continue to be accounted for under ASC 842. In most instances, bankruptcy law requires that any unpaid prepetition lease payments for affirmed leases become current and the continuing lease payments remain current throughout the proceedings. Leases that are amended by the lessor during the bankruptcy process should be accounted for under the lease modification guidance in ASC 842. See LG 5 for guidance on modification and remeasurement of a lease.

Finally, leases rejected in the bankruptcy process will usually result in the leased property being returned to the lessors. Lease liabilities are not secured debt. As the lessee can reject the lease and return the right-of-use asset or negotiate a shorter lease term or lower lease payments, lease liabilities are generally subject to compromise. Lease liabilities generally become subject to compromise on the petition date (and not when management files a motion to reject a lease). Unpaid lease payments, including any damages to lessors for terminating the leases (often calculated by formulas used by the Court), usually become allowed claims subject to compromise. The Bankruptcy Code places limits on the maximum amounts of allowed claims for certain types of executory contracts, including leases. Following the guidance in ASC 852-10, such claims should be recorded at the allowed claim amounts and not the amounts expected to be paid to the lessors.

3.8A Leases under ASC 840 during bankruptcy

During a bankruptcy proceeding, a debtor's existing lease agreements will be affirmed, amended, or rejected. Until the Court approves an action, the debtor should continue to accrue its lease payments and recognize the associated expense in accordance with ASC 840, Leases, even if it expects the accrued lease liability to ultimately be compromised. Lease liabilities should continue to be recognized until rejected leases are approved by the Court. Leases affirmed in the bankruptcy process without modification should continue to be accounted for under ASC 840. In most instances, bankruptcy law requires that any unpaid prepetition lease payments for affirmed leases become current and the
continuing lease payments remain current throughout the proceedings. Leases that are amended by the lessor during the bankruptcy process should be accounted for under the lease modification guidance in ASC 840.

Finally, leases rejected in the bankruptcy process will usually result in the leased property being returned to the lessors. Unpaid lease payments, including any damages to lessors for terminating the leases (often calculated by formulas used by the Court), usually become allowed claims subject to compromise. The Bankruptcy Code places limits on the maximum amounts of allowed claims for certain types of executory contracts, including leases. Following the guidance in ASC 852-10, such claims should be recorded at the allowed claim amounts and not the amounts expected to be paid to the lessors.

Example BLG 3-3 describes how a reporting entity going through bankruptcy proceedings should account for a rejected lease agreement.

**EXAMPLE BLG 3-3**

**Accounting treatment for a rejected lease agreement**

Prior to entering into a Chapter 11 reorganization proceeding, a reporting entity with a December 31 year-end vacates office space subject to an operating lease, and pursuant to ASC 420, *Exit or Disposal Cost Obligations*, accrues a liability for the remaining lease payments, net of any expected subrental income. On November 30, the reporting entity files a petition for Chapter 11. During the bankruptcy proceeding, the operating lease is rejected by the reporting entity. The rejected lease claim is allowed by the Bankruptcy Court on January 2 for an amount less than the carrying amount of the existing liability.

What is the amount of the lease liability that the reporting entity should report in its December 31 financial statements?

**Analysis**

As noted at BLG 3-2, ASC 852-10 generally does not change the application of GAAP. Further, ASC 852-10-10-1 indicates that the purpose of financial statements of entities in Chapter 11 is to reflect the evolution of the bankruptcy proceeding. The reporting entity should therefore continue to report the lease liability in its December 31 financial statements in accordance with ASC 420. When the rejection of the lease is approved by the Court, the liability should be adjusted to the amount allowed by the Bankruptcy Court.

**3.9 Other contractual arrangements during bankruptcy**

During a bankruptcy proceeding, a debtor’s contractual arrangements will be affirmed, amended, or rejected. Existing GAAP should continue to be followed until a reporting entity takes action (i.e., rejects) a contract and the Court subsequently approves such action. Adjustments for any expected allowed claims resulting from any amendments or rejections to an executory contract should be recognized when the Court approves such action.
3.10 Applying ASC 852-10 to the income statement during bankruptcy

The income statement of a reporting entity in bankruptcy will reflect changes due to the evolution of the bankruptcy process according to ASC 852-10-45-9. Items related to the bankruptcy should be presented separately in the financial statements. ASC 852-10-45-9 states:

ASC 852-10-45-9
The statement of operations shall portray the results of operations of the reporting entity while it is in Chapter 11. Revenues, expenses (including professional fees), realized gains and losses, and provisions for losses resulting from the reorganization and restructuring of the business shall be reported separately as reorganization items, except for those required to be reported as discontinued operations in conformity with Subtopic 205-20.

Figure BLG 3-5 illustrates a sample income statement for the period ended December 31, 202X for a reporting entity in bankruptcy as of December 31, 202X.

**Figure BLG 3-5**
Sample income statement under ASC 852-10

<table>
<thead>
<tr>
<th>J&amp;B Industries</th>
<th>December 31, 202X</th>
</tr>
</thead>
<tbody>
<tr>
<td>(Debtor-in-possession)¹</td>
<td></td>
</tr>
<tr>
<td>Consolidated income statement</td>
<td></td>
</tr>
<tr>
<td>(in millions, except per share amounts)</td>
<td></td>
</tr>
<tr>
<td>Net sales</td>
<td>$ 2,250</td>
</tr>
<tr>
<td>Operating expenses:</td>
<td></td>
</tr>
<tr>
<td>Cost of sales</td>
<td>2,070</td>
</tr>
<tr>
<td>Selling, general and administrative</td>
<td>220</td>
</tr>
<tr>
<td>Other expenses</td>
<td>30</td>
</tr>
<tr>
<td>Loss from continuing operations before interest, reorganization items, and income taxes</td>
<td>(70)</td>
</tr>
<tr>
<td>Interest expense (contractual interest of $49)²</td>
<td>35</td>
</tr>
<tr>
<td>Reorganization items, net³</td>
<td>65</td>
</tr>
<tr>
<td>Loss from continuing operations before income taxes</td>
<td>(170)</td>
</tr>
<tr>
<td>Income tax benefit</td>
<td>5</td>
</tr>
<tr>
<td>Net loss</td>
<td>$ (165)</td>
</tr>
<tr>
<td>Basic and diluted loss per common share</td>
<td>$ (0.55)</td>
</tr>
</tbody>
</table>

¹ All financial statements labelled as “Debtor-in-possession” until reporting entity’s emergence from bankruptcy.
² Reporting entities often disclose on the face of the income statement the contractual interest expense that would have been recorded absent the limits on unsecured interest while in bankruptcy.
³ Expenses related to the bankruptcy proceedings are shown separately to distinguish such transactions and events from ongoing operations.
3.10.1 Reorganization items during bankruptcy

The primary method of distinguishing transactions and events associated with the reorganization in the income statement is through the use of a separate line for reorganization items. The reporting entity uses this category to reflect the revenues, expenses, gains, and losses that are the result of the reorganization of the business during the bankruptcy.

Judgment is required in determining which items should be reported as reorganization items within the income statement. Items are only classified as reorganization items during bankruptcy if they result from the reorganization of the business. No activity should be classified as a reorganization item before the bankruptcy filing or after bankruptcy emergence, even if the activity relates to the bankruptcy. In addition:

- It would be rare to report revenues as a reorganization item.
- As a general rule, only incremental costs directly related to the reporting entity’s bankruptcy filing, such as professional fees for bankruptcy services, should be presented as reorganization items.
- Recurring internal costs of normal operations should not be presented as reorganization items.
- Impairment charges and restructuring activities would also not usually be considered reorganization items because these costs are associated with the ongoing operations of the business.
- Adjustments relating to prepetition estimates of liabilities, or the correction of errors, would not typically be recorded as reorganization items.
- Changes in the balance sheet accounts from the application of the principles of ASC 852-10, such as adjustments to the expected amount of the allowed claims for liabilities subject to compromise discussed earlier, should be recorded as reorganization items.
- The related tax effects from reorganization items should be reflected in income tax expense.

In summary, only those costs initiated directly as a result of the bankruptcy filing and which would not have otherwise been incurred by the reporting entity may be presented as reorganization items. For example, a debtor may reject a lease during bankruptcy as part of a broad restructuring plan to exit an unprofitable region or product offering. It may not be appropriate to classify the gain or loss related to the lease termination as a reorganization item. The debtor would have to assess whether it would have exited the unprofitable region or product offering regardless of the bankruptcy. If the bankruptcy filing was not the direct cause of the impairment charge or the restructuring activity, then the activity should generally not be recorded as a reorganization item.

Reorganization activities associated with a component that is required to be reported as discontinued operations under ASC 205-20, Presentation of Financial Statements, should be separately reported as reorganization items within the discontinued operations section of the income statement. Accordingly, for disposal transactions that qualify as discontinued operations, the gain or loss associated with the sale of assets, and the related selling costs, would also be recorded as discontinued operations.

For disposal transactions that do not qualify as discontinued operations, a question may arise as to how a reporting entity should classify the gain or loss associated with the sale of assets, and the related
selling costs, which are completed as part of a Court-approved plan of reorganization. It is generally expected that disposal gains or losses, and the related selling costs, would be recognized as part of ongoing operations. However, such amounts may be included as a reorganization item when the reporting entity is able to demonstrate that the asset is being sold only as a direct result of its bankruptcy proceedings as required by a Court-approved plan and would not have otherwise been disposed of in the ordinary course of business.

In accordance with ASC 852-10-45-12, interest income earned by a reporting entity in bankruptcy that would not have been earned except for the proceedings, which often occurs because the debtor is not allowed to pay prepetition debts during the proceedings, should be reported within reorganization items. However, in accordance with ASC 852-10-45-2, if a reporting entity can reasonably estimate the portion of interest income applicable to its normal invested working capital, and thus, can distinguish that portion as related to the ongoing operations of the business, it should report that amount separately within the income statement.

Figure BLG 3-6 provides an example of a footnote disclosure for reorganization items for a reporting entity in bankruptcy.

**Figure BLG 3-6**

Sample note disclosure (abridged)\(^1\) – Reorganization items

Professional advisory fees and other costs directly associated with our reorganization are reported separately as reorganization items pursuant to ASC 852-10. Professional fees include legal and other advisory fees related to the bankruptcy proceedings. Reorganization items also include provisions and adjustments to the carrying values of debt and certain other prepetition liabilities to reflect their Court-approved settlement amounts. The reorganization items in the consolidated income statement for the year ended December 31, 20X1, consisted of the following items:

<table>
<thead>
<tr>
<th>Year ended December 31, 20X1</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Professional fees</td>
<td>$ 55</td>
</tr>
<tr>
<td>Debt valuation adjustments</td>
<td>5</td>
</tr>
<tr>
<td>Other prepetition liabilities adjustments</td>
<td>15</td>
</tr>
<tr>
<td>Interest income</td>
<td>(10)</td>
</tr>
<tr>
<td>Total reorganization items, net</td>
<td>$ 65</td>
</tr>
</tbody>
</table>

\(^1\) The sample note disclosure illustrates an abridged version of what a reporting entity in bankruptcy would disclose for reorganization items. It is not meant to be an all-inclusive representation of what information would need to be disclosed in the note. A reporting entity should consider the specific facts and circumstances surrounding its reorganization items and disclose accordingly.

### 3.10.2 Interest expense during bankruptcy

The Bankruptcy Code specifically limits postpetition interest on unsecured debt, but allows claims for postpetition interest on secured debt in certain instances. Interest accruing on unsecured debt subsequent to the date of petition generally would not be allowed as a claim unless there is surplus (a solvent debtor) and all unsecured creditors will receive full payment for their claims. Interest accruing
on secured debt is allowed when the collateral securing the claims exceeds the principal amount of the debt and any accruing interest is secured.

ASC 852-10-45-11 provides guidance regarding reporting interest expense during bankruptcy.

**ASC 852-10-45-11**

Interest expense shall be reported only to the extent that it will be paid during the proceeding or that it is probable that it will be an allowed priority, secured, or unsecured claim. Interest expense is not a reorganization item.

Creditors also may be allowed to add reasonable fees, costs, and other charges incurred in connection with the bankruptcy proceedings to their claims, which could require the debtor to adjust the carrying amount of the claims in its financial statements.

Since some of a reporting entity’s interest cost likely will not be accruing during the bankruptcy proceedings, this could have a significant impact on the results of operations because of lower interest expense being reflected in the current financial statements as compared to prior periods. Therefore, the contractual interest that would have accrued absent the bankruptcy filing should be disclosed in the notes to the financial statements or on the face of the income statement. Interest expense that will be accrued during the bankruptcy proceedings, including interest related to debtor-in-possession financing, is not included in reorganization items.

In certain circumstances, the Court may approve for the debtor to make adequate protection payments to its creditor. Adequate protection payments are intended to provide a secured (or partially secured) creditor consideration during the bankruptcy proceedings to compensate it from the loss in value of the collateralized asset the debtor continues to use in its operations. For example, the debtor may have a loan with a creditor which is secured by a manufacturing facility. Because the debtor will continue to operate the manufacturing facility during the bankruptcy proceedings, thereby precluding the creditor from accessing the collateral to minimize its losses as a creditor, the Court may approve adequate protection payments to compensate for the potential loss in value of the collateral due to the debtor’s continued use of the facility. Given the nature of the payment, adequate protection payments are generally treated as a reduction in principal. However, the debtor should consider whether some or all of the payments should be treated as interest.

**Question BLG 3-6**

May a reporting entity that has filed for bankruptcy continue to capitalize interest related to an active construction project if interest expense is no longer being recognized on the project debt?

**PwC response**

No. Unless interest on the project debt is being incurred in bankruptcy, capitalization would not be appropriate.
Question BLG 3-7

How should a reporting entity in bankruptcy treat dividends on mandatorily redeemable preferred stock that is classified as mezzanine equity?

PwC response

While ASC 852 specifically addresses accounting for interest expense in a reorganization proceeding, it does not address the accounting for equity instruments with characteristics of debt such as mandatorily redeemable preferred stock. The debtor should carefully consider the terms of each of its equity instruments, including any modifications made to the instruments by the Court, to ensure an appropriate accounting model is being followed.

In cases where it is not expected that the Court will allow a claim for future dividends after filing for bankruptcy, we believe it is acceptable to analogize to ASC 852-10-45-11 (which addresses interest expense in a reorganization proceeding). Under this approach, the reporting entity would cease accrual of such preferred stock dividends as of the bankruptcy filing date, if the criteria in ASC 852-10-45-11 are met.

3.11 Applying ASC 852-10 to the statement of cash flows during bankruptcy

Per ASC 852-10-45-13, reorganization items should be disclosed separately within the operating, investing, and financing categories of the statement of cash flows. Supplemental cash flow disclosures might also be required.

ASC 852-10-45-13

Reorganization items shall be disclosed separately within the operating, investing, and financing categories of the statement of cash flows. This presentation can be better accomplished by the use of the direct method of presenting the statement. Paragraph 230-10-45-25 lists the operating items that shall be reported separately when the direct method is used. That paragraph encourages further breakdown of those operating items if the entity considers such a breakdown meaningful and feasible. Further identification of cash flows from reorganization items should be provided to the extent feasible. For example, interest received might be segregated between estimated normal recurring interest received and interest received on cash accumulated because of the reorganization. If the indirect method is used, details of operating cash receipts and payments resulting from the reorganization shall be disclosed in a supplementary schedule or in the notes to financial statements.

The cash flows associated with principal and interest payments on debtor-in-possession financing should not be separated as reorganization items (from other financing items) in the statement of cash flows. The reasons are that financing is required to fund the reporting entity's ongoing activities while carrying out the reorganization plan and the debtor-in-possession financing is not classified as a liability subject to compromise.

Reorganization items paid or received during the period that are classified as operating cash flows should be separately disclosed. Reorganization items that are noncash adjustments should be
Accounting and reporting during bankruptcy

disclosed in the statement of cash flows or notes to the financial statements. Investing and financing cash flows from reorganization items are usually presented on the face of the statement of cash flows.

3.12 Assets held for sale during bankruptcy

Often a reporting entity will sell assets in connection with its reorganization proceedings. The presentation of assets held for sale under the guidance in ASC 360, Property, Plant, and Equipment, should be considered. One required criterion for the determination of whether the assets qualify for such treatment is whether management, having the appropriate authority, has approved the sale. For a reporting entity in bankruptcy, such authority may rest with the Court. Similarly, assets classified as held for sale at the time of filing a petition for bankruptcy may need to be reconsidered as such classification may no longer be appropriate given that management may no longer have the ability to complete a sale. In instances where the Court must approve the sale, held-for-sale classification is usually not appropriate until Court approval is obtained.

3.13 Assets held and used during bankruptcy

If a reporting entity determines that it will continue to operate its long-lived assets during its reorganization proceedings, the long-lived assets should continue to be classified as held and used. The reporting entity should not cease depreciating long-lived assets that are to be held and used and should evaluate the remaining useful lives of such assets. As the reorganization proceedings continue to progress, management should reassess the appropriateness of the held and used classification when facts and circumstances indicate that the assets may be sold.

3.14 Impairment of long-lived assets during bankruptcy

A reporting entity that has filed a petition for bankruptcy should continue to assess its long-lived assets for indicators of impairment in accordance with the provisions of ASC 360-10. The nature of the asset (i.e., held and used or held for sale) determines how to measure and record such impairment in the financial statements. A reporting entity should consider the significance of any changes to the reorganization plan affecting expected cash flow forecasts of its asset groups as well as a reporting entity’s commitment to a plan to sell long-lived assets.

Events or changes in circumstances that arise from the ongoing bankruptcy proceedings may result in a material and sustained decrease in the cash flows generated from long-lived assets that are held and used. Adverse interactions with customers, suppliers, and vendors are examples of factors that would impact the cash flow projections used in the recoverability test for long-lived assets in most scenarios. Additional examples of factors, commonly referred to as impairment indicators or triggering events, are included in ASC 360-10-35-21.

If a reporting entity meets all of the criteria in ASC 360-10-45-9 to classify assets as held for sale, the disposal group should be reported at its fair value, less cost to sell, beginning in the period the held-for-sale criteria are met. See PPE 5.3 for additional information.

3.15 Derivatives during bankruptcy

Management should consider the impact of the bankruptcy on the reporting entity's derivative positions. As discussed at BLG 2.6, a reporting entity’s derivative contracts may have lost their hedging
effectiveness in the period leading up to the bankruptcy filing. Many derivative contracts, including derivatives subject to International Swaps and Derivatives Association (ISDA) rules, are automatically terminated upon the filing of bankruptcy as an event of default. In such a case, the reporting entity will need to account for the termination under the appropriate derivatives guidance, which would include the cessation of hedge accounting and the recognition in the income statement of amounts previously deferred in AOCI. Amounts in AOCI that relate to forecasted transactions that are no longer probable of occurring should be evaluated in accordance with ASC 815-30-40-4. If the occurrence of the transaction is in doubt, any related amounts in AOCI may need to be recognized in the income statement. Additionally, a receivable from or payable to the counterparty should be recorded. Any amounts owed may need to be classified as liabilities subject to compromise.

The continued application of hedge accounting to any contracts that are not terminated in bankruptcy should be carefully considered. For instance, counterparty risk and the probability of forecasted transactions for cash flows hedges may change.

Prior to filing for bankruptcy, a reporting entity might present a liability from a derivative or other financial instrument at a significant discount from its contractual amount (e.g., accounted for at fair value at a significant discount, which reflects the increased credit risk of the reporting entity). However, once the reporting entity files for bankruptcy, the measurement of a liability falls under the guidance of ASC 852-10, and the liability should be measured at the expected amount of the allowed claim, which could be significantly in excess of its pre-bankruptcy carrying amount. The adjustment to the expected amount of the allowed claim should be included within reorganization items in the income statement.

### 3.16 Share-based compensation during bankruptcy

Often in bankruptcy proceedings the equity interests of a reporting entity are ultimately cancelled by the Court. Until the Court takes action with respect to share-based compensation awards, a reporting entity in bankruptcy should continue to account for its employee and nonemployee equity awards in accordance with ASC 718. In other words, while a reporting entity should not consider the Court’s anticipated actions to modify or cancel the awards, the reporting entity would continue to consider its underlying assumptions, such as probability of achieving a performance target or estimating forfeitures.

In situations where the Court modifies or cancels the awards, a reporting entity should account for such action on the date the modification or cancellation becomes effective in accordance with ASC 718-20-35.

ASC 718-20-35-8 notes that the cancellation of an award that is accompanied by the concurrent grant of (or offer to grant) a replacement award should be accounted for as a modification of the terms of the cancelled award.

Alternatively, as noted in ASC 718-20-35-9, when the cancellation of the equity awards is not accompanied by the concurrent grant of replacement awards approved by the Court, the awards should be accounted for as repurchases for no consideration, with any unrecognized compensation expense related to the cancelled awards recorded in the income statement. However, since the awards were not forfeited, the reporting entity should not reverse any previously recognized compensation expense related to the cancelled awards.
If a successor reporting entity (i.e., a new accounting entity applying fresh start accounting) grants awards to employees or nonemployees post-emergence, the awards are typically not viewed as replacement awards for the previous awards held by the employee or nonemployee, since a new accounting entity is issuing the awards. A successor reporting entity should treat any new awards as new grants post-emergence.

### 3.17 Deferred taxes during bankruptcy

During a bankruptcy proceeding, a reporting entity should continue to assess the realizability of its deferred tax assets in accordance with ASC 740. While the need for a valuation allowance is subject to management’s judgment, it would be unusual for a reporting entity in bankruptcy to not have at least a partial valuation allowance related to its deferred tax assets. In assessing the need for a valuation allowance prior to bankruptcy, a reporting entity may have contemplated certain operational and tax planning strategies whose execution was in the control of management. See BLG 2.7.3 for discussion of valuation allowance considerations prior to entering bankruptcy.

Once in bankruptcy, the execution of such strategies may be outside of the control of management since typically the Court will have the final approval on any strategic initiatives. Management should assess the likelihood of implementing any such strategies in light of the bankruptcy proceeding, and the resulting impact, if any, on the valuation allowance. See TX 5 for further discussion of valuation allowance assessments.

### 3.18 Consolidation during bankruptcy

The filing of the bankruptcy petition by one or more companies within a consolidated group gives rise to consolidation issues depending on which companies are included in the filing. It is important to understand the legal entities and subsidiaries that are included in a Chapter 11 filing. In some cases, only certain subsidiaries, but not the parent, are included in the filing. In other cases, some subsidiaries are excluded from a parent’s Chapter 11 filing. The specific provisions of ASC 852 apply only to bankrupt entities. Some of the more common scenarios are presented below.

#### 3.18.1 Bankrupt subsidiary and nonbankrupt parent

Under ASC 810-10-15, consolidation of a majority-owned subsidiary is precluded where control does not rest with the majority owners—for instance, where the subsidiary is in legal reorganization or bankruptcy. Accordingly, when a subsidiary files for bankruptcy, it is usually appropriate for a solvent parent to deconsolidate the subsidiary. Under ASC 810, this loss of control would likely trigger a gain or loss for the parent as the parent would remeasure its retained noncontrolling investment at fair value. The parent should consider whether it needs to separately recognize any obligations related to its ownership of the subsidiary, which may reduce the gain or increase the loss upon deconsolidation. Examples of such obligations might include the parent’s guarantees of subsidiary debt or other obligations for which the Court might hold the parent responsible. A parent that has lost control and deconsolidated a bankrupt subsidiary for which the parents provides a guarantee of the subsidiary’s debt should recognize a liability under the guidance in ASC 460, Guarantees, for the fair value of the guarantee. In the unusual circumstance when a parent has not lost control of its bankrupt subsidiary, the recognition of a guarantee liability would not be appropriate.
Question BLG 3-8
When should a parent company, which is not in bankruptcy, deconsolidate a subsidiary that has filed for bankruptcy?

PwC response
A parent deconsolalates a subsidiary as of the date the parent no longer has control of the subsidiary. Examples of events that result in deconsolidation of a subsidiary include when a subsidiary becomes subject to the control of a government, court, administrator, or regulator. Normally, once a subsidiary files for bankruptcy protection, a parent no longer has control over the subsidiary (as the Court must approve all significant actions), and the subsidiary should be deconsolidated on that date. See BCG 1.1 for discussion on the definition of control.

Question BLG 3-9
Should a parent company, which is not in bankruptcy and has a negative investment in a subsidiary, recognize a gain upon the subsidiary’s filing for bankruptcy?

PwC response
Following the guidance in ASC 810-10, a parent would derecognize the negative investment and determine the amount of gain or loss to recognize on the date of the bankruptcy filing. The parent should consider the fair value of its retained investment when making this determination. This includes consideration of whether it needs to separately recognize any obligations related to its ownership of the subsidiary, which would reduce the gain or increase the loss on deconsolidation (e.g., the parent has guaranteed, or the Court will hold the parent liable for, certain obligations of the subsidiary).

Upon deconsolidation, the equity method in ASC 323 usually should not be used to account for a majority-owned subsidiary that is not consolidated because, as a result of bankruptcy, the parent usually does not have significant influence over the investee. Some of the factors to consider in determining if the parent should apply the equity method include whether (1) the parent company operates the subsidiary as a debtor-in-possession, (2) other factors indicate that the creditors and other beneficiaries (e.g., litigants) will be made whole in the bankruptcy proceeding (i.e., there are no substantive adverse parties), (3) the facts indicate that the subsidiary will be in bankruptcy for a relatively short period of time, and (4) the bankruptcy filing is being used by the parent company to accomplish certain narrow objectives (such as the rejection of selected leases).

Accordingly, assuming the reporting entity is precluded from applying ASC 810 or ASC 323, it should account for its equity investments in accordance with ASC 321, Investments—Equity Securities, which generally requires equity investments to be measured at fair value with changes in fair value recorded in current earnings. However, entities may elect a measurement alternative per ASC 321-10-35-2 if the equity investment does not have a readily determinable fair value and does not qualify for the practical expedient to estimate fair value in accordance with ASC 820-10-35-59. The measurement alternative initially measures a reporting entity’s investment at cost. The investment is remeasured to fair value if impaired or upon an observable price change that results from an orderly transaction of an identical or similar investment from the same issuer.
A reporting entity should make an election to use the measurement alternative for each investment separately and reassess at each reporting period whether the equity investment continues to qualify to be measured in accordance with ASC 321-10-35-2. See LI 2.3 for additional discussion of the accounting for equity investments.

When a nonbankrupt parent deconsolidates a bankrupt subsidiary, the parent should consider whether the historical operating results of that subsidiary should be reported as discontinued operations following the criteria in ASC 205 and ASC 360. If the parent concludes at the time of deconsolidation that the former subsidiary does not qualify for discontinued operations, the subsequent disposition of an investment accounted for in accordance with ASC 321-10-35-2 would not be eligible for discontinued operations treatment.

**Question BLG 3-10**

Should a nonbankrupt parent continue to consolidate a variable interest entity (VIE) which has filed for bankruptcy?

**PwC response**

When a nonbankrupt parent consolidates a VIE prior to the VIE’s filing for bankruptcy, the parent should consider whether it is still the primary beneficiary of the VIE after the VIE files for bankruptcy. Generally, the parent would no longer be able to assert that it has the power to direct the activities of the VIE that most significantly impact the VIE’s economic performance. Such power typically resides with the Court once the VIE has filed for bankruptcy.

**3.18.2 Bankrupt parent and nonbankrupt subsidiary**

A bankrupt parent should continue to consolidate its nonbankrupt subsidiary because the parent continues to control the subsidiary, notwithstanding the fact that the parent is controlled by the Court.

**3.18.3 Bankrupt parent and bankrupt subsidiary**

The treatment when both the parent and any subsidiaries are in bankruptcy depends on how the bankruptcy case is treated by the Court. In some cases, a bankrupt parent effectively retains control of a bankrupt subsidiary because they are under the same Court jurisdiction and will be viewed as a group during the bankruptcy process (the group's assets will be used to settle the claims of the group's creditors). Therefore, in the eyes of the Court and the creditors, the bankrupt parent and subsidiary are viewed as one entity and continued consolidation may be appropriate.

In other situations, even though both the parent and subsidiary are under the jurisdiction of the same Court which will administer the bankruptcy on a joint basis, the Court may respect the individual entity claims and assets available to satisfy those claims. In these instances, the parent and subsidiary would be described more accurately as under the supervision of the Court. In this situation, the presentation of combined, as opposed to consolidated, financial statements may be more appropriate.

Finally, if the bankrupt parent and bankrupt subsidiary are in different legal jurisdictions, continued consolidation or combined presentation would generally not be appropriate.
3.18.4 Reporting entity disclosure requirements during bankruptcy

When one or more entities in the consolidated group are in bankruptcy and one or more entities in the consolidated group are not in bankruptcy, the reporting entity is required under ASC 852-10-45-14 to disclose in its consolidated financial statements the condensed combined financial statements of only the entities in bankruptcy. Generally, these condensed combined financial statements are presented in a footnote disclosure. For example, if a parent company and two of its three subsidiaries have filed for bankruptcy, and one of the subsidiaries has not filed for bankruptcy, the parent company financial statements should separately include the condensed combined financial statements of only the entities in bankruptcy. If all entities in the consolidated group are in bankruptcy, the requirement to present the condensed combined financial statements is not applicable. Refer to BLG 7.3 for further discussion of these disclosure requirements.

3.18.5 Intercompany balances during bankruptcy

Intercompany balances may exist between affiliated entities in which only certain of the entities are included in a Chapter 11 filing. When outstanding balances of a parent or subsidiary represent a claim in bankruptcy against a debtor, they should be accounted for the same as claims with an unaffiliated third party.

In instances when a parent has lost control of a bankrupt subsidiary and the subsidiary has an intercompany payable to the former parent or another parent-controlled entity, the entity in bankruptcy should no longer recognize an intercompany payable on its books. Such amounts should be recorded as liabilities subject to compromise at the expected amount of the allowed claim in the same manner as amounts due to unaffiliated third party creditors.

In situations when a parent has lost control of a bankrupt subsidiary and that subsidiary has an intercompany receivable from its former parent or another parent-controlled entity, the entity in bankruptcy should no longer recognize an intercompany receivable on its books. Such amounts should be recorded as a receivable in accordance with ASC 310 as if they were owed from a third party.

3.18.6 Foreign currency during bankruptcy

When an entity in a consolidated group files for bankruptcy protection, it may deconsolidate or lose significant influence over an investment in a foreign entity. A foreign entity, as defined in ASC 830, Foreign Currency Matters, is a distinct and separable operation (for example, subsidiary, division, branch, joint venture) that is combined, consolidated, or accounted for using the equity method of accounting and has a functional currency other than the reporting entity’s reporting currency. See FX 8.5 for a discussion on the guidance to consider when accounting for the deconsolidation of a foreign entity and the recognition of any cumulative translation adjustment associated with such an event.

3.19 Sales of assets during bankruptcy

Commonly in a Chapter 11 bankruptcy proceeding, the parties may determine that the best course for the creditors would be a Court-sponsored sale of some or all of the debtor’s assets, which can occur through a Court-approved auction under Section 363 of the Bankruptcy Code or as part of the debtor’s reorganization plan under Section 1129 of the Bankruptcy Code. From the perspective of the debtor, such a sale is accounted for consistently with any other divestiture of its operations, even though the
sale is supervised and approved by the Court and can involve a substantial portion of the reporting entity's net assets.

See BLG 5.2 for further discussion of each of these types of sales, including the corresponding advantages and accounting implications.

3.20 SEC reporting during bankruptcy

Entities operating under bankruptcy protection are not relieved of their obligations to report periodically under the Securities Exchange Act of 1934 (Exchange Act). Companies operating under the bankruptcy laws might be eligible for relief from certain SEC filing duties under the Exchange Act provided the conditions noted in Staff Legal Bulletin No. 2 (SLB 2) are met. SLB 2 sets forth a framework for registrants to seek an accommodation from the Division of Corporation Finance to replace their quarterly (Form 10-Q) and annual (Form 10-K) financial reports with the monthly financial reports that must be filed with the Court. (See BLG 1.5 for discussion of monthly financial reports.) This accommodation, which must be requested from the SEC staff, is not automatic, and it relates only to the filing of Forms 10-Q and 10-K. SLB 2 provides guidance for preparing the accommodation request and indicates some elements the SEC staff might consider in evaluating the request. The monthly reports should be filed with the SEC on a Form 8-K within the time frame agreed upon in the accommodation request.

Registrants that have filed on Form 8-K all monthly reports required by the Bankruptcy Code while in bankruptcy may request an accommodation from the SEC to file a comprehensive annual report on Form 10-K upon emergence from bankruptcy. Such an accommodation releases the registrant from having to file multiple interim and annual reports, but generally does not reduce the information that would otherwise be included in such reports. Requests to file a comprehensive Form 10-K should be directed to the Office of the Chief Accountant, Division of Corporation Finance. If granted, the accommodation will allow the filing of a comprehensive Form 10-K, including all audited financial statements and other material information that would have been available had the registrant filed timely, complete reports during bankruptcy. This comprehensive report also must include unaudited quarterly financial statements in a level of detail consistent with the requirements of Rule 10-01(a) and (b) of Regulation S-X. The comprehensive Form 10-K will also need to include a discussion of operating results, trends, and liquidity for each interim and annual period.

This relief from the Form 10-K and Form 10-Q filing requirements does not apply to the registrant's other Exchange Act reporting obligations—for example, Form 8-K filings to disclose any material events related to the bankruptcy proceedings or other events, such as a sale of the debtor's assets or deconsolidation of a majority-owned subsidiary. Generally, any Form 8-K must continue to be filed during bankruptcy within four business days after the occurrence of a material event. At a minimum, public companies would be expected to file a Form 8-K upon filing for bankruptcy, as significant milestones are met, upon confirmation of the reorganization plan, and upon emergence. Once a reporting entity emerges from bankruptcy, it should file a Form 8-K that includes an audited balance sheet as of the date of emergence and resume filing all required financial reports in future periods.

The SEC staff has indicated that the filing of a comprehensive Form 10-K would not result in the registrant being considered “current.” This may impact the registrant’s ability to use certain SEC forms (e.g., Form S-8) and may have other implications. Additionally, the SEC staff has indicated that the registrant would not be eligible for Form S-3-level disclosures until it establishes a sufficient history of
making timely filings. Companies should consult with their legal counsel to ensure that all relevant implications are being considered.

### 3.21 Application of ASC 852-10 for foreign enterprises during bankruptcy

A foreign reporting entity that prepares financial statements under US GAAP will have to use judgment in determining whether to apply ASC 852-10 to its financial statements if the bankruptcy petition was filed in a country other than the United States. Because each country has its own bankruptcy laws, there may be significant differences in the proceedings that would necessitate different accounting treatments and financial reporting considerations. However, a foreign reporting entity filing bankruptcy under its local judicial proceedings should consider following the guidance in ASC 852 when those judicial proceedings are similar to Chapter 11 in the US.
Chapter 4: 
Emerging from bankruptcy – 
updated February 2023
4.1 **Emerging from bankruptcy: Chapter overview**

A reporting entity emerging from bankruptcy must record the effects of its reorganization plan. In most cases, the reporting entity will also qualify for fresh-start reporting whereby balance sheet items are adjusted to their fair values to denote a “fresh start” upon emergence from bankruptcy. If the criteria to apply fresh-start reporting are met, the reporting entity should apply fresh-start reporting once the Court has confirmed the reporting entity’s reorganization plan and it has emerged from Chapter 11.

This chapter outlines the criteria and application of fresh-start reporting, as well as guidance for a reporting entity that does not qualify for fresh-start reporting. Throughout the chapter, references are made to the “predecessor” and “successor” companies when applying fresh-start reporting. As discussed in BLG 4.4, the separate references are the result of the predecessor company exiting the bankruptcy process and becoming the successor company as a result of applying fresh-start reporting. This successor company is considered to be a “new” reporting entity, separate from the predecessor for accounting and financial reporting purposes. In essence, as a result of its emergence from bankruptcy and the adoption of fresh-start reporting, the reporting entity has a new beginning, which should be reflected in its financial statements.

4.2 **When to adopt fresh-start reporting (bankruptcy emergence)**

An eligible entity should apply fresh-start reporting at the later of (1) the date that the Court has confirmed its reorganization plan or (2) the date that all material unresolved conditions precedent to the plan’s becoming binding are resolved. ASC 852-10-45-17 and ASC 852-10-45-18 provide guidance on the financial reporting when entities emerge from a Chapter 11 reorganization.

**ASC 852-10-45-17**

Entities whose plans have been confirmed by the court and have thereby emerged from Chapter 11 shall apply the reporting principles in paragraphs 852-10-45-19 through 45-29 as of the confirmation date or as of a later date, as discussed in the following paragraph, when all material conditions precedent to the plan’s becoming binding are resolved.

**ASC 852-10-45-18**

The effects of a plan should be included in the entity’s financial statements as of the date the plan is confirmed. However, inclusion shall be delayed to a date not later than the effective date if there is a material unsatisfied condition precedent to the plan’s becoming binding on all the parties in interest or if there is a stay pending appeal. That might occur, for example, if obtaining financing for the plan or for the transfer of material assets to the debtor by a third party is a condition to the plan’s becoming effective. Financial statements prepared as of the date after the parties in interest have approved a plan through the voting process, and issued after the plan has been confirmed by the court, shall report the effects of the plan if there are no material unsatisfied conditions.
Question BLG 4-1

Can a reporting entity in bankruptcy with a quarter-end of March 31 adopt fresh-start reporting in its March 31 financial statements when the Court has approved the reporting entity’s reorganization plan prior to March 31, but a material condition precedent to the plan (e.g., obtaining exit financing) remains unresolved?

PwC response

No. Even though the reporting entity’s plan is “approved” by the Court as of March 31, ASC 852-10-45-18 clarifies that adoption of fresh-start reporting should not occur until all material conditions precedent to the plan becoming binding are resolved. Obtaining exit financing is usually considered a material condition. Therefore, the reporting entity should not adopt fresh-start reporting in its March 31 financial statements, but should consider providing appropriate subsequent events pro forma disclosures reflecting its expected emergence and the effect it will have on the reporting entity’s financial statements.

See BLG 4.5.7 for discussion of subsequent event disclosures.

As a practical matter, entities may choose a period-end date near the confirmation date to use as the date for applying fresh-start reporting to eliminate the need to perform the period-end financial reporting process twice within the same month (upon emergence and again at month-end). The use of a “convenience date” near the plan’s effective date may be permissible if it does not have a material effect on the financial statements and no material transaction has occurred between the convenience date and emergence date. When considering materiality, a reporting entity should ensure it is assessing both quantitative metrics, such as net income, revenues, and expenses in the predecessor and successor periods, and qualitative factors, such as debt covenant compliance and the impact on employee compensation arrangements. A materiality assessment should consider the impact of using a convenience date together with the effect of other errors in the financial statements.

For example, assume a reporting entity’s plan of reorganization is confirmed on April 27 and the reporting entity has a calendar month-end close date. The reporting entity may adopt fresh-start reporting as of April 30 if operating results since April 27 are not material to either the predecessor or successor periods. In this circumstance, the reporting entity should date its financial statements as of and for the period ended April 27 (i.e., the date of emergence) but would include the immaterial results of operations for the three-day period between April 27 and 30 in its pre-emergence reporting period. A reporting entity should consider the impact of fresh-start accounting adjustments (e.g., the effects of the forgiveness of debt, adjustments to reported amounts of assets and liabilities) in its materiality assessment when deciding whether or not it can utilize a convenience date.

The initial successor period should not include the effects (e.g., gain) of emerging from bankruptcy and fresh-start adjustments. For this reason, the use of a convenience date that crosses the end of an annual (or quarterly, in the case of a public company) financial reporting period is limited as the fresh-start adjustments should not be reported in a financial reporting period prior to the actual adoption. For example, if the reporting entity’s annual or quarterly period end is April 30 and the reorganization plan was confirmed as of May 3, the reporting entity should not use a convenience date as of April 30 and record the effects of emerging from bankruptcy in its financial statements for the period ended April 30. Example BLG 4-1 demonstrates this point.
EXAMPLE BLG 4-1

Use of convenience date near a period-end

Company A is a calendar year-end reporting entity. On January 3, 202X, Company A emerged from bankruptcy and applied fresh-start reporting in accordance with ASC 852-10. The last day of the predecessor’s operations is January 2, 202X (the date the plan of reorganization was confirmed). Therefore, Company A would have predecessor financial statements as of and for the prior year ended December 31, 202X and the two-day period ended January 2, 202X.

Can Company A apply the effects of the fresh-start adjustments in its December 31, 202X, financial statements?

Analysis

Companies may not use a convenience date for the adoption of fresh-start accounting that crosses a reporting period end. The effects of any fresh-start adjustments should be recorded in the final predecessor income statement in the financial statement period that includes the date of emergence from bankruptcy. Therefore, in this instance, the adjustments pursuant to fresh-start reporting would be recorded during the two-day period ended January 2, 202X, the final day of the predecessor’s operating results. The December 31, 202X, financial statements should not include the effects from the emergence from bankruptcy. However, Company A should consider including subsequent events disclosures regarding its emergence from bankruptcy and presenting a December 31, 202X pro forma balance sheet reflecting the anticipated effect of applying fresh-start reporting. See BLG 4.5.7 for discussion of subsequent events disclosures.

4.3 Criteria for applying fresh-start reporting (bankruptcy emergence)

A reporting entity must apply fresh-start reporting upon emergence from bankruptcy if it meets both of the following criteria:

- The reorganization value of the emerging entity immediately before the date of confirmation is less than the total of all postpetition liabilities and allowed claims, which is sometimes referred to as being “balance sheet insolvent,” and
- The holders of existing voting shares immediately before confirmation of the plan of reorganization receive less than 50% of the voting shares of the emerging entity.

Figure BLG 4-1 depicts application of these criteria.
4.3.1 **Reorganization value (bankruptcy emergence)**

The reorganization value of the reporting entity is determined through the plan of reorganization in the Chapter 11 process and generally approximates the fair value of the reporting entity before considering liabilities. The reorganization value approximates the amount a willing buyer would pay for the assets of the reporting entity immediately after the restructuring. In some cases, all of the assets in the bankrupt reporting entity will not be included in the reporting entity that emerges from bankruptcy. In that case, the reorganization value should include the value attributed to the reconstituted entity, as well as the value of those assets that will be disposed of before reconstitution occurs.

The reorganization value is the basis for determining the value received by the reporting entity’s creditors and equity holders determined after extensive arm’s-length negotiations between the parties in interest as overseen and approved by the Court. The reorganization value is usually determined as a range of value rather than a single point estimate; however, the reporting entity will choose a value within the range to use to apply fresh-start reporting. Though several methods can be used to determine the reorganization value, it is generally derived using a discounted cash flow approach.

**Question BLG 4-2**

For a reporting entity emerging from bankruptcy with a Court approved reorganization value between $100 and $120, are there circumstances where management can utilize a reorganization value outside of that Court approved range (i.e., either below $100 or above $120)?

**PwC response**

The reorganization value represents the arm’s length negotiations between all parties interested in the bankruptcy proceedings. Accordingly, it would not be appropriate in most instances to use a value...
outside of the Court approved range even in circumstances where market conditions have changed and indicate that the reorganization value is either above or below the range approved by the Court.

The reorganization value used in bankruptcy accounting is different from the business enterprise value (also referred to as “market value of invested capital” or “total invested capital”). A reporting entity’s enterprise value represents the fair value of its interest-bearing debt and its shareholders’ equity. In most bankruptcy proceedings, a valuation specialist will determine the emerging entity’s enterprise value. The reorganization value can usually be derived from the enterprise value by adding back liabilities other than interest-bearing debt. However, reporting entities should evaluate the specific inputs and assumptions used by the valuation specialist in determining the enterprise value to appropriately reconcile to the reorganization value. For instance, consideration of other items (e.g., non-core assets, estimated cash balances, environmental liabilities, working capital deficiencies/surpluses, as applicable) may be necessary. Deferred taxes that will be recorded in connection with fresh-start reporting may also impact reorganization value.

Figure BLG 4-2 depicts a comparison of reorganization value and enterprise value.

**Figure BLG 4-2**
Reorganization value and enterprise value

As an example, assume a reporting entity's enterprise value is $1,250,000, and $200,000 of working capital liabilities and other liabilities exist at emergence date. Reconciliation between the enterprise and reorganization values is illustrated below.

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Enterprise value</td>
<td>$ 1,250,000</td>
</tr>
<tr>
<td>Working capital liabilities and other liabilities (at emergence date)</td>
<td>200,000</td>
</tr>
<tr>
<td>Reorganization value</td>
<td>$ 1,450,000</td>
</tr>
</tbody>
</table>
In most instances, enterprise value will not include the value of cash and noncore assets and liabilities of the enterprise. For instance, assets to be sold in reorganization, excess cash, tax credits, and net operating loss carryforwards are often excluded from the enterprise valuation. Also, legacy pension costs or environmental liabilities may not be included in the reconstituted entity and, therefore, may not be considered when determining the enterprise value of the reconstituted entity. In such cases, a reporting entity may need to also adjust for these items to derive the reorganization value. If these items were already included in the cash flows used to derive the enterprise value estimate, they would not be adjusted when determining the reorganization value.

4.3.2 Change in ownership of shares (bankruptcy emergence)

The second criterion when assessing whether the reporting entity qualifies for fresh-start reporting requires a comparison of the percentage of the reporting entity’s shares held by the shareholder group prior to emergence to the percentage of shares held by that group after emergence from bankruptcy. The criterion for applying the 50% threshold to the voting shares is in relation to a change in the voting interest below the 50% level and not that a single party obtains a controlling interest. In other words, in order to qualify for fresh-start reporting, a reporting entity must demonstrate that its existing shareholder group, as a group, has lost control of the reporting entity, but it need not demonstrate that a single party has obtained control. The loss of control contemplated by the plan must be substantive and not temporary. That is, the new controlling interest must not revert to the shareholders that held interests immediately before the plan was filed or confirmed.

In this calculation, potentially dilutive instruments, such as warrants and options, are generally disregarded. For example, assume existing shareholders immediately prior to emergence receive little or none of the voting shares in the emerging entity because debt holders or other creditors receive equity in exchange for the reporting entity’s debt obligations. Since the debt holders and other creditors receive more than 50% of the voting interest in the emerging entity, the second criterion necessary to apply fresh-start reporting has been met, even if no single holder obtains control.

4.4 Applying fresh-start reporting (bankruptcy emergence)

According to ASC 852-10-45-20 and ASC 852-10-45-21, adjustments are made in the predecessor accounts upon emerging from bankruptcy and adopting fresh-start reporting.

Excerpt from ASC 852-10-45-20

Entities that adopt fresh-start reporting in conformity with the preceding paragraph shall apply the following principles:

a. The reorganization value of the entity shall be assigned to the entity’s assets and liabilities in conformity with the procedures specified by Subtopic 805-20. If any portion of the reorganization value cannot be attributed to specific tangible or identified intangible assets of the emerging entity, such amounts shall be reported as goodwill in accordance with paragraph 350-20-25-2.

b. ... 

c. Deferred taxes shall be determined under the requirements of paragraph 852-740-45-1.
The financial statements of the entity as of and for the period immediately preceding the date determined in conformity with the guidance in paragraph 852-10-45-17 shall reflect all activity through that date in conformity with the guidance in paragraphs 852-10-45-1 through 45-16. Additionally, the effects of the adjustments on the reported amounts of individual assets and liabilities resulting from the adoption of fresh-start reporting and the effects of the forgiveness of debt shall be reflected in the predecessor entity’s final statement of operations. Forgiveness of debt, if any, shall be reported as an extinguishment of debt and classified in accordance with Subtopic 220-20. Adopting fresh-start reporting results in a new reporting entity with no beginning retained earnings or deficit. When fresh-start reporting is adopted, the notes to the initial fresh-start financial statements shall disclose the additional information identified in paragraph 852-10-50-7.

The emergence from bankruptcy and adoption of fresh-start reporting are generally displayed in the footnotes using a four-column format that presents (1) the balance sheet just prior to confirmation of the reorganization plan, (2) reorganization adjustments, (3) fresh-start adjustments, and (4) the opening balance sheet of the successor entity. The typical format is illustrated in Example BLG 4-2.

The predecessor's final income statement should reflect the impact of adopting fresh-start reporting and the recognition of reorganization items. The income statement will include the effects of adjustments to individual assets and liabilities, forgiveness of debt, and separately, any related tax effects. While ASC 852-10-45-21 explicitly requires the effects of adjustments of assets and liabilities resulting from the application of fresh-start reporting to be reflected in the income statement, it does not provide guidance on how adjustments to equity should be recorded. Typically as part of its emergence from bankruptcy, the predecessor company’s equity will be cancelled and new equity of the successor company will be issued. We believe the cancellation of predecessor equity (i.e., capital stock) in fresh-start reporting generally should be recorded as a direct adjustment to equity and should not be reflected in the predecessor’s final income statement.

The impact of emerging from bankruptcy and adopting fresh-start reporting on significant areas of the balance sheet is discussed below.

4.4.1 **Assets (bankruptcy emergence)**

The reorganization value of the reporting entity should be assigned to the reporting entity’s assets similar to acquisition accounting in ASC 805, *Business Combinations*, which generally involves recording the assets at fair value in accordance with ASC 820, *Fair Value Measurement*. The recognition of identifiable intangible assets could result in previously unrecognized intangible assets being recorded. Appropriate consideration should be given to the period of benefit of the intangible assets and pattern of consumption (i.e., useful life and method of amortization). If a portion of the reorganization value cannot be attributed to specific tangible or identified intangible assets of the emerging entity, that amount should be recorded as goodwill. Adjustments to the carrying amounts of assets as a result of the application of fresh-start reporting should be recorded through the predecessor’s income statement as reorganization items.

While acquisition accounting under ASC 805 is used to apply fresh-start reporting, an important distinction is that in fresh-start reporting, the adjustment to record the reporting entity’s net assets to their respective fair values is recorded in the predecessor’s income statement as a “fresh-start adjustment.” Conversely, in a business combination, the acquirer records the target’s assets and
Emerging from bankruptcy

4.4.2 Liabilities (bankruptcy emergence)

Prepetition liabilities are settled by the debtor in accordance with the reorganization plan approved by the Court. A creditor may receive cash, equity or debt securities in the emerged entity, or a combination thereof in settlement. Any difference between the fair value of the consideration the creditor receives and the allowed claim amount should be recognized in the income statement of the predecessor as a reorganization item.

In many instances, a new debt issuance is negotiated by a reporting entity prior to emergence. Any costs associated with the debt issuance should be accounted for as either a direct deduction from the face amount of the note or capitalized as an asset, depending on the debt instrument issued. See FG 1.2.2 and FG 1.3 for further information. Upon emergence, the associated debt would be required to be recorded at fair value through the application of fresh-start reporting.

Adjustments for the effects of the reorganization plan include settlement of prepetition liabilities discussed in earlier chapters of this guide. Liabilities incurred to settle prepetition balances are recorded at fair value taking into consideration the settlement terms of the reorganization plan. For example, assume under the reorganization plan that a $70 allowed claim is settled for future cash payments that have a fair value of $40. The reorganization adjustment upon confirmation would include a $30 gain for this particular liability ($70 allowed claim less the fair value of future payments of $40).

Deferred revenue recorded at emergence should relate to a performance obligation of the reporting entity that will continue to exist upon emergence from bankruptcy, such as an obligation to provide goods, services, or the right to use an asset.

In October of 2021, the FASB issued ASU 2021-08, Business Combinations (Topic 805): Accounting for Contract Assets and Contract Liabilities from Contracts with Customers. This guidance requires contract assets and contract liabilities (i.e., deferred revenue) acquired in a business combination to be recognized and measured by the acquirer on the acquisition date in accordance with ASC 606, Revenue from Contracts with Customers. As ASC 852-10-45-20(a) requires the reorganization value to be assigned in conformity with ASC 805, we believe that a reporting entity applying fresh-start accounting that has contract assets or contract liabilities at emergence should apply the principles in ASC 805-20-25-28(C), which require the reporting entity to measure the contract assets or contract liabilities at emergence in accordance with ASC 606.

ASU 2021-08 is effective for public business entities for fiscal years beginning after December 15, 2022, including interim periods within those fiscal years. For all other entities, the new guidance is effective for fiscal years beginning after December 15, 2023, including interim periods within those fiscal years. Entities should apply the guidance in ASU 2021-08 on a prospective basis for emergence dates on or after the effective date. Early adoption is permitted, including in an interim period, for any period for which financial statements have not yet been issued. For more information on ASU 2021-08, refer to BCG 2.5.16.

Prior to the adoption of ASU 2021-08, entities emerging from bankruptcy would often adjust their pre-existing deferred revenue balances, recording the liability at fair value similar to other liabilities recognized upon emergence. Fresh-start adjustments to the carrying value of liabilities should be
recorded as a reorganization item. See FV 7.3.3.6 for further discussion of fair value adjustments to deferred revenue.

If post-retirement benefit plans are amended as part of the reorganization plan, the effects of changes to the plans should be included in determining the accumulated post-retirement benefit obligations of the fresh-start reporting entity. The net gain or loss resulting from the adjustment, settlement, or curtailment of the benefit obligations or assets required by the plan of reorganization should be reported separately as a reorganization item by the predecessor. The measurement of the plan obligation and plan assets should be based on current assumptions (such as discount rate and expected long-term rate of return on plan assets) as of the emergence date. Planned or anticipated changes to benefit plans that are not part of the reorganization plan would be accounted for prospectively.

4.4.3 **Preconfirmation contingencies (bankruptcy emergence)**

Prior to the issuance of ASC 805, Practice Bulletin 11, *Accounting for Preconfirmation Contingencies in Fresh-Start Reporting* (PB 11), provided specific guidance on the accounting for contingent assets and liabilities at the time of plan confirmation. In most cases, these items are estimated as of the fresh-start adoption date since these items are considered during the bankruptcy process and the parties in interest implicitly have determined their value in connection with developing the reorganization plan. After application of fresh-start reporting, if the actual settlement of the contingent asset or liability differed from the estimate, the adjustment was recorded in the income statement of the emerged entity (i.e., the successor entity) and not as an adjustment to the opening balance sheet. While ASC 805 nullified PB 11, we believe such adjustments would still continue to be recorded in the income statement in the period following emergence.

4.4.4 **Equity (bankruptcy emergence)**

It is not uncommon for multiple classes of securities (e.g., preferred stock, common stock, or options and warrants thereon) to be issued in conjunction with a reporting entity’s plan of reorganization. The fair value of each security should be determined considering the reporting entity’s enterprise value. A proper determination of value for each class of security is important because the accounting for subsequent equity transactions could be influenced by the initial determination of fair value (e.g., subsequent issuances of share-based awards to employees).

Retained earnings, or accumulated deficit, is zero for the newly emerged entity. In addition, AOCI, including the cumulative translation adjustment, is zero upon emergence. Adjustments to the components of AOCI generally should be recorded through the income statement, consistent with the impact of applying fresh-start reporting to the respective assets or liabilities which gave rise to the component of other comprehensive income. Each component of AOCI should be carefully assessed to ensure appropriate treatment.
Example BLG 4-2 illustrates a four-column presentation, including reorganization and fresh-start reporting adjustments, for a simplified fact pattern.

**EXAMPLE BLG 4-2**

Example of reorganization and fresh-start reporting adjustments

Company A is a calendar year-end public business entity that has experienced financial hardship and accordingly filed for bankruptcy on March 31, 202X. On September 30, 202X, the Court approved the reorganization plan submitted by Company A and on December 1, 202X Company A emerged from bankruptcy. At emergence, Company A qualifies for fresh-start reporting. Assume the following additional facts:

- At the time of the confirmation of the plan of reorganization by the Court (September 30, 202X), liabilities subject to compromise payable to various lenders were determined to be $4,000.

- On the plan effective date (December 1, 202X), $50 of cash was used to pay professional fees incurred as part of the reorganization. Such costs were not previously accrued within accounts payable and were recognized on the plan effective date.

- Also on the plan effective date, Company A issued new term notes with a face amount of $500. Company A incurred costs associated with obtaining the new term notes in the amount of $25. The fair value of the new term notes is $490 on the plan effective date.

- The reorganization plan, as confirmed by the Court, calls for the issuance of shares of the successor’s common stock to Company A’s former lenders (i.e., its liabilities subject to compromise) in satisfaction of the claims for Company A’s debts.

- The midpoint of the enterprise value of Company A, as confirmed by the Court, is $3,400, which contemplates cash, debt and equity of the successor. The reorganization value is $4,000.

- The predecessor’s common stock will be cancelled on the plan effective date.

- Company A hired a valuation firm to assist in the determination of fair value for the assets and liabilities of the emerged entity.

- For ease of illustration, the tax impacts of adopting fresh-start reporting have been ignored.

How would Company A show the reorganization and fresh-start adjustments using a 4-column format in the December 1, 202X balance sheet?
### Analysis

<table>
<thead>
<tr>
<th></th>
<th>Predecessor</th>
<th>Reorganization adjustments</th>
<th>Fresh-start adjustments</th>
<th>Successor</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$100</td>
<td>$425</td>
<td>$</td>
<td>$525</td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>400</td>
<td>-</td>
<td>-</td>
<td>400</td>
</tr>
<tr>
<td>Property, plant, &amp; equipment</td>
<td>2,000</td>
<td>-</td>
<td>600</td>
<td>2,600</td>
</tr>
<tr>
<td>Goodwill</td>
<td>100</td>
<td>-</td>
<td>100</td>
<td>200</td>
</tr>
<tr>
<td>Intangible assets</td>
<td>-</td>
<td>-</td>
<td>275</td>
<td>275</td>
</tr>
<tr>
<td><strong>Total assets</strong></td>
<td>$2,600</td>
<td>$425</td>
<td>$975</td>
<td>$4,000</td>
</tr>
<tr>
<td>Accounts payable</td>
<td>400</td>
<td>-</td>
<td>-</td>
<td>400</td>
</tr>
<tr>
<td>Accrued liabilities</td>
<td>200</td>
<td>-</td>
<td>-</td>
<td>200</td>
</tr>
<tr>
<td>Long-term debt</td>
<td>-</td>
<td>475</td>
<td>15</td>
<td>490</td>
</tr>
<tr>
<td>Liabilities subject to compromise</td>
<td>4,000</td>
<td>(4,000)</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td><strong>Total liabilities</strong></td>
<td>$4,600</td>
<td>$ (3,525)</td>
<td>$15</td>
<td>$1,090</td>
</tr>
<tr>
<td>Predecessor common stock</td>
<td>10</td>
<td>(10)</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Predecessor additional paid-in capital</td>
<td>690</td>
<td>(690)</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Successor common stock</td>
<td>-</td>
<td>100</td>
<td>-</td>
<td>100</td>
</tr>
<tr>
<td>Successor additional paid-in capital</td>
<td>-</td>
<td>2,810</td>
<td>-</td>
<td>2,810</td>
</tr>
<tr>
<td>Retained earnings (accumulated deficit)</td>
<td>(2,700)</td>
<td>1,740</td>
<td>960</td>
<td>-</td>
</tr>
<tr>
<td><strong>Total stockholders’ equity (deficit)</strong></td>
<td>$ (2,000)</td>
<td>$3,950</td>
<td>$960</td>
<td>$2,910</td>
</tr>
<tr>
<td><strong>Total liabilities and stockholders’ equity</strong></td>
<td>$2,600</td>
<td>$425</td>
<td>$975</td>
<td>$4,000</td>
</tr>
</tbody>
</table>
Emerging from bankruptcy

(1) Reorganization adjustments reflect the sources and uses of cash on the effective date:

**Sources:**
- Proceeds from issuance of new term notes $500

**Uses:**
- Payment of costs associated with obtaining the new term notes (25)
- Payment of professional fees on the effective date directly attributed to the bankruptcy (50)

**Net cash activity on the effective date** $425

(2) Reorganization adjustments to reflect the issuance of new term notes on the effective date of $500, offset by $25 of issuance costs associated with obtaining the term notes.

(3) Reorganization adjustment to reflect the cancellation of predecessor common stock and APIC in accordance with the plan of reorganization. It would also be acceptable to reflect this adjustment within the Fresh-start adjustments column.

(4) Reorganization adjustment to reflect the settlement of $4,000 of liabilities subject to compromise in accordance with the plan of reorganization as follows:

- Liabilities subject to compromise $4,000
- New common stock and paid-in-capital used to satisfy lender claims (2,910)
- Gain on settlement of liabilities subject to compromise $1,090

(5) Fresh-start adjustments to PP&E, goodwill, intangible assets, and long-term debt reflect the adjustments of the assets and liabilities of the successor to their fair values, including intangible assets not previously recognized:

- Property, plant, & equipment $600
- Goodwill (excess of reorganization value above identifiable assets) 100
- Intangibles 275
- Long-term debt (15)
- Total adjustments $960

(6) Fresh-start adjustment to retained earnings (accumulated deficit) to reset the accumulated deficit to zero.

Note that the gain recorded on emergence would be $2,050, which reflects the gain on settlement of liabilities subject to compromise of $1,090 and the total adjustments from adopting fresh-start reporting of $960.

The first three columns of the table above represent accounting by Company A (the predecessor) in the period just prior to emergence. The fourth column represents the opening balance sheet for Company A (the successor) after the adoption of fresh-start reporting. The total assets on the opening balance sheet are equal to the reorganization value. Equity of the new reporting entity equals the enterprise value less the fair value of interest-bearing debt issued.

**Enterprise value to reorganization value reconciliation**

<table>
<thead>
<tr>
<th>Description</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Enterprise value</td>
<td>$3,400</td>
</tr>
<tr>
<td>Accounts payable</td>
<td>400</td>
</tr>
<tr>
<td>Accrued liabilities</td>
<td>200</td>
</tr>
<tr>
<td>Reorganization value</td>
<td>$4,000</td>
</tr>
</tbody>
</table>
4.4.5 Leases (bankruptcy emergence)

Entities emerging from bankruptcy should assess changes to existing leases as a result of Court-approved modifications to the lease terms. If the terms of a reporting entity’s lease agreements have been modified during the reorganization process, the reporting entity should reassess the classification of any such lease on the date of the modification. Upon emerging from bankruptcy, a reporting entity should not otherwise reassess the classification for each of its lease agreements, which is consistent with the guidance for a business combination. See BCG 4.3.3.7 for further discussion of the treatment of lease agreements in a business combination. LG 5 addresses the accounting for modifications, including termination, of a lease contract under ASC 842. It also addresses the accounting for lease remeasurements for events that are not modifications.

When accounting for a lease acquired in a business combination in accordance with ASC 805-20-25-8, the classification of a lease contract is based on the contractual terms at the inception of the contract, unless the contract has been significantly modified. A reporting entity emerging from bankruptcy should continue to classify its leases in the same manner it did prior to entering into bankruptcy unless the modifications to the agreement made as a result of the reorganization plan are deemed to constitute a new agreement.

Changes in classification and modifications made to leases that existed prior to bankruptcy should be reflected in the predecessor financial statements. In accordance with the guidance in ASC 852-10-45-21, the effects of the adjustments on the reported amounts of individual assets and liabilities resulting from the adoption of fresh-start reporting are reflected in the predecessor entity's final income statement. When a reporting entity concludes that a lease modification resulting from its reorganization plan should be accounted for as a new lease, the new lease should be recorded as of the modification date when approval is received from the Court.

Assets and liabilities associated with leases should be recognized as of the date of emergence at fair value in accordance with the provisions of ASC 805.

4.4.6 Share-based compensation (bankruptcy emergence)

In a typical bankruptcy proceeding, where a reporting entity is insolvent, the pre-bankruptcy share-based compensation awards are usually worthless and canceled by the Court along with the reporting entity's outstanding shares. In this scenario, the awards are accounted for as a cancellation with no replacement awards pursuant to ASC 718-20-35-9. Accordingly, the predecessor recognizes any remaining unrecognized compensation expense related to the canceled awards and generally will recognize a deferred tax asset to the extent of the book compensation expense recorded, which likely will be accompanied by an increase in a related valuation allowance.

The cancellation of the awards results in a write-off of the deferred tax asset and the related valuation allowance. A shortfall results because the tax deduction (which is zero) is less than the book compensation expense (which is not reversed). Write-offs of deferred tax assets, net of any valuation allowance, are charged to the income statement.

New share-based compensation awards granted to employees by the emerging entity should be accounted for as new awards in accordance with ASC 718. When new awards of the successor entity are granted prior to its emergence from bankruptcy, the reporting entity should consider whether any compensation cost should be attributed to the predecessor period. Compensation cost is generally recognized over the requisite service period, which begins with the service-inception date. Typically,
the service-inception date is the same as the grant date. However, the service-inception date could precede the grant date when the criteria from ASC 718-10-55-108 through ASC 718-10-55-109 are satisfied. See SC 2.6.4 for additional information.

4.4.7 **Taxes (bankruptcy emergence)**

When fresh-start reporting is applied, deferred taxes are recorded to reflect differences between fair values and tax bases of the assets and liabilities, similar to a business combination. A deferred tax asset is established for any loss or tax credit carryforwards. In the unusual circumstance that tax-deductible goodwill exceeds the book goodwill recorded through the allocation of reorganization value, a deferred tax asset is also recorded for the excess tax basis through an adjustment to goodwill, using a simultaneous equation to determine the gross-up deferred tax asset. However, if book goodwill exceeds tax-deductible goodwill, no deferred tax liability is recorded. A valuation allowance should be recognized for net deferred tax assets if realization is not considered more likely than not (a likelihood greater than 50 percent) based on all available evidence.

Bankruptcy plans of reorganization often create ownership changes pursuant to Section 382 of the Internal Revenue Code. In general, Section 382 imposes an annual limitation on a corporation’s use of its net operating losses, certain built-in losses, and credit carryforwards if there has been more than a 50% change in ownership of the corporation’s stock. The annual limitation, however, may not apply to a corporation emerging from a bankruptcy or similar proceedings. Specifically, if the emerging corporation meets the following criteria, it is eligible to elect to not have the Section 382 limitation apply: (1) immediately before the change, the corporation is under the jurisdiction of the Court in a Chapter 11 or similar case and (2) the shareholders and creditors of the corporation immediately before the change (i.e., the predecessor) own 50% or more of the stock, in vote and value, of the reorganized corporation after the change (i.e., the successor). In these circumstances, the amount of the net operating losses and credit carryforwards may be recomputed to exclude certain interest deductions and other adjustments previously reported by the predecessor. However, if an ownership change occurs within two years of the date the reporting entity emerges from bankruptcy, the losses and carryforwards will be effectively eliminated. If a corporation does not meet the eligibility criteria or is eligible but elects to apply the Section 382 limitation, the limitation is determined using a modified calculation. In particular, the equity value of the corporation (the basis for calculating the limitation) is measured after the reduction of creditors’ claims in the reorganization.

Consideration should also be given to the assessment of the valuation allowance for deferred tax assets that are recorded in fresh-start reporting. It may be necessary to consider the extent to which the weight of available evidence provides assurance that the reorganized enterprise will have future taxable income from sources other than reversals of temporary differences. This is a significant area of judgment and the analysis should focus on the post-reorganization outlook of the reporting entity.

Similar to the guidance under ASC 805, the post-confirmation release of a valuation allowance established in fresh-start reporting is recorded in earnings (subject to the intraperiod allocation principles of ASC 740, *Income Taxes*). Likewise, subsequent adjustments to liabilities or benefits for uncertain tax positions generally are recorded in earnings. Other tax considerations, such as a reporting entity’s indefinite reinvestment assertion for foreign earnings under ASC 740-30, may be impacted upon the reporting entity’s emergence from bankruptcy. For reasons such as these, the effective tax rate may be more volatile in periods following the emergence from bankruptcy.

For tax purposes, a reporting entity generally realizes income from the cancellation of indebtedness (COD) when the indebtedness is satisfied for less than the tax basis in the debt. COD income is
excluded from taxable gross income if the cancellation is granted by the Court or is pursuant to a liquidation or reorganization plan approved by the Court. Any COD income excluded from gross income under this bankruptcy exception is generally applied to reduce certain tax attributes and tax basis of the reporting entity in the following order: net operating losses, general business credits, minimum tax credits, capital losses, basis of property, passive activity loss and credit carryovers, and foreign tax credits. Companies can make an election to change the order to instead first reduce the basis of property. In either case, the basis of property is reduced only to the extent aggregate tax bases exceed total liabilities.

A reduction in tax attributes such as net operating losses or credit carryforwards would result in a write-off of any related deferred tax assets. If a valuation allowance exists against the assets, it would be released. When there is excess COD income after reducing tax attributes, the excess is permanently excluded from the reporting entity's taxable income without ever generating a corresponding attribute reduction. This amount is commonly referred to as “black hole” income. However, black hole income may result in the recognition of a tax liability to the extent it triggers tax on an excess loss account. An excess loss account relates to a parent reporting entity’s tax basis in its investment in a subsidiary which may not have previously resulted in a deferred tax liability on the basis that the tax law provided a means through which the tax could be avoided.

However, the specific tax attributes and bases to be reduced are not identified until the end of the tax year that includes emergence from bankruptcy. This is generally considered favorable to the successor because tax attributes and tax bases used to reduce current year taxable income and tax liability are not available for reduction. The appropriate accounting upon emergence for the taxable and deductible temporary difference from the discharge of debt will depend on facts and circumstances.

To account for deferred taxes as part of fresh-start reporting we believe the reporting entity should project taxable income (and other changes in tax attributes) between emergence and the end of the tax year and record deferred taxes based on the attributes and tax bases expected to be in existence at the end of the tax year. This is consistent with the principles of ASC 740 which require the recognition of deferred taxes for the estimated future tax effects attributable to temporary differences. Importantly, ASC 740-270-25-2 requires the use of an Annual Effective Tax Rate (AETR) for purposes of calculating the interim provision (see TX 16.2). This requires an estimate of both ordinary income (or loss) as well as an estimate of tax for the year. If a reporting entity is able to estimate ordinary income (or loss) for purposes of determining the AETR, the impact of that estimate on attributes and tax bases generally should be considered in recording deferred taxes as part of fresh-start accounting. Under this approach, the successor period will only be impacted to the extent that the activity in the successor period is different from the projection at the fresh-start date.

However, in a case where a reporting entity is unable to reliably estimate its successor activity, the reporting entity would record deferred taxes without adjusting for changes in tax attributes and tax bases estimated to occur by the end of the tax year. This approach will likely result in a larger impact to the effective tax rate in the successor period than if the reporting entity had utilized projections to determine the attribute reduction at the fresh-start date.

The true-up of the deferred tax amount at the end of the tax year would generally be recorded in the financial statements of the successor entity to the extent it represents a change in estimate.
4.5 Fresh-start reporting considerations (bankruptcy emergence)

There are various reporting considerations for entities that qualify for fresh-start reporting. The following sections discuss certain financial statement presentation and other reporting considerations for entities that are required to apply fresh-start reporting.

4.5.1 Financial statement presentation (bankruptcy emergence)

Fresh-start financial statements prepared by a reporting entity emerging from Chapter 11 will not be comparable with those prepared before its emergence because the financial statements are those of a new accounting entity. Thus, comparative financial statements that include a new basis of accounting and cover the period encompassing the emergence date should not be presented as financial statements covering a single period. ASC 852-10-45-26 and ASC 852-10-45-27 provide guidance on fresh-start reporting of comparative financial statements.

ASC 852-10-45-26

Fresh-start financial statements prepared by entities emerging from Chapter 11 will not be comparable with those prepared before their plans were confirmed because they are, in effect, those of a new entity. Thus, comparative financial statements that straddle a confirmation date shall not be presented.

ASC 852-10-45-27

Regulatory agencies may require the presentation of predecessor financial statements. However, such presentations shall not be viewed as a continuum because the financial statements are those of a different reporting entity and are prepared using a different basis of accounting, and, therefore, are not comparable. Attempts to disclose and explain exceptions that affect comparability would likely result in reporting that is so unwieldy it would not be useful.

For example, it would not be appropriate for a reporting entity with a December 31 year-end, for which fresh-start reporting was adopted as of April 30, to present a single income statement for the 12 months ended December 31. Rather, the reporting entity should prepare the income statement for two separate periods: (1) the pre-emergence, debtor-in-possession period of January 1 through April 30 and (2) the post-emergence period of May 1 through December 31. This would also be applicable for the statements of cash flows, of stockholders’ equity, and of comprehensive income. In addition, the relevant footnote tables would be presented for the two distinct accounting periods. Typically, this would involve separate disclosures for the pre- and post-fresh-start periods for income statement items affected by the fresh-start reporting, such as depreciation and interest expense, income tax effects, and other items.

For the financial statements and footnotes, the reporting entity would generally include a vertical “black line” between the reporting for the two distinct companies to highlight to the reader that the financial statements have been prepared using two different bases of reporting. The columns related to the two accounting entities are generally labeled “Predecessor Company” and “Successor Company,” or similar designations. A discussion of the basis for presentation is also included in the footnotes to notify the reader that as a consequence of fresh-start reporting, the reporting entity’s results of operations, balance sheets, and cash flows after adopting fresh-start reporting are not comparable.
Emerging from bankruptcy

with those prior to the fresh-start period, and therefore have been segregated in the respective financial statements. As discussed in SEC FRM 13210.2, predecessor financial statements are required to be retrospectively adjusted to reflect the impact of a successor's discontinued operations. We believe that other items are not required to "cross the black line." See further discussion in BLG 4.5.3.

4.5.2 Adoption of new accounting policies and pronouncements (bankruptcy emergence)

An entity adopting fresh-start reporting can generally set new accounting policies for the successor independent of those followed by the predecessor. The reporting entity emerging from bankruptcy typically is not required to demonstrate preferability for its new accounting policies, as the successor entity represents a new reporting entity for financial reporting purposes. For example, an entity adopting fresh-start reporting may elect to (1) apply the fair value option in accordance with ASC 825, *Financial Instruments*, or (2) switch from LIFO to FIFO to account for inventory. However, if the successor entity adopts a new policy, and results of the predecessor entity's historical operations are also included in the financial statements, clear disclosure should be made of the difference in accounting policies between the predecessor and successor entities.

When considering the adoption of new accounting policies and the potential impact future accounting standards might have on the revised policies, the reporting entity should ensure that early adoption of the future accounting standards is permitted by the standard. That is, the reporting entity should not adopt new accounting guidance prior to its permitted effective date if early adoption is not permitted by the standard. When a new accounting standard requires retrospective application, it is not necessary to adopt the standard in the predecessor entity's financial statements.

4.5.3 Discontinued operations (bankruptcy emergence)

When a successor entity has a component or group of components that is disposed of or classified as held for sale and qualifies for discontinued operations reporting, the reporting entity's financial statements should reflect the results of operations of the component in discontinued operations. Questions arise as to whether the predecessor should also present discontinued operations since that reporting entity is the "old" accounting entity that did not have a disposition. The SEC staff has expressed a view that the predecessor's financial statements should reflect the impact of a successor's discontinued operations. The staff commented that it believes this presentation enhances comparability for all fiscal periods. See FSP 27 for additional information on discontinued operations.

4.5.4 Allocation of goodwill to reporting units (bankruptcy emergence)

Adopting fresh-start reporting may result in goodwill being recorded, which represents the excess reorganization value over the identified assets recorded in accordance with ASC 805. Management will need to consider its operating structure post-emergence to determine how goodwill should be assigned to the entity's reporting units. The assignment of goodwill is necessary for impairment testing, which is required to be assessed at least annually or when an interim triggering event occurs. ASC 350-20-35-42 to ASC 350-20-35-43 describes two approaches a reporting entity might follow when assigning goodwill to reporting units: an acquisition method approach and a "with-and-without" approach. The use of either approach to assigning goodwill is dependent on facts and circumstances and should be reasonable and supportable. Refer to BCG 9 for additional information on allocating goodwill to reporting units.
**4.5.5 Changes in segment reporting (bankruptcy emergence)**

For public entities, the application of ASC 280, *Segment Reporting*, impacts both disclosures and the unit of account for goodwill impairment testing. Reporting entities emerging from bankruptcy may need to change their segments to reflect changes to the organization’s structure, as well as how their chief operating decision maker (CODM) allocates resources and assesses performance post-bankruptcy. Changes in operating segments may change the determination of reportable segments. See FSP 25 for additional segment reporting considerations.

**4.5.6 Measurement period (bankruptcy emergence)**

ASC 805 provides for a measurement period of one year after the closing date of an acquisition. We believe a measurement period generally does not exist when applying fresh-start reporting as this guidance was not incorporated into ASC 852-10. Furthermore, given the length of time that a bankrupt entity is typically in reorganization and the level of detail about the reporting entity’s operations included in a reorganization plan, a measurement period to obtain facts necessary to measure identified assets or liabilities or to identify additional assets and liabilities that exist at the emergence date is generally not necessary. Therefore, adjustments to assets and liabilities subsequent to the adoption of fresh-start reporting are generally the result of post-emergence events and should be included in the results of operations in the period in which they occur. However, procedures necessary to complete the allocation of reorganization value to the reporting entity’s assets (e.g., adjusting provisional plant, property, and equipment amounts to final appraised values) may be appropriate. When a reporting entity makes adjustments to the allocation of its reorganization value, it should also consider the effects of the adjustment on depreciation, amortization, or other income or expense recognized in prior periods.

**4.5.7 Pro forma balance sheet presentation (bankruptcy emergence)**

Entities emerging from bankruptcy subsequent to period-end will often present a pro forma balance sheet in the notes to their financial statements describing the application of fresh-start reporting on those period-end balances. This presentation is based on guidance in ASC 855, *Subsequent Events*, which describes presenting a pro forma balance sheet as of period-end if the subsequent event is of such significance that the disclosure can best be described by providing pro forma financial data. The emergence from bankruptcy subsequent to period-end generally is one of those types of events. This pro forma financial data typically is presented in a four-column format as shown in Example BLG 4-2 and would include applicable notations as to the basis for the adjustments presented.

**4.6 Entities not qualifying for fresh-start reporting (bankruptcy emergence)**

For entities not qualifying for fresh-start reporting, the effects of the bankruptcy are recorded through the financial statements, and a new accounting entity is not created. Therefore, the financial statements are not divided between the pre- and post-bankruptcy periods (i.e., predecessor and successor financial statements are not presented).
ASC 852-10-45-29

Entities emerging from Chapter 11 that do not meet the criteria in paragraph 852-10-45-19 do not qualify for fresh-start reporting. Liabilities compromised by confirmed plans shall be stated at present values of amounts to be paid, determined at appropriate current interest rates. Forgiveness of debt, if any, shall be reported as an extinguishment of debt and classified in accordance with Subtopic 220-20.

When most of a reporting entity’s liabilities are restated as a result of restructurings or modifications that occur under the purview of the Court, the provisions of ASC 470-60, Troubled Debt Restructurings by Debtors, do not apply. With that in mind, the following should be considered at the emergence date:

- Liabilities that were compromised under the bankruptcy process are recorded at the present value of the amounts to be paid, which can differ from fair value, with any resulting gain generally being recorded as a reorganization item.
- Asset values and uncompromised liabilities’ carrying amounts are not adjusted to fair value.
- Retained earnings or accumulated deficit and accumulated other comprehensive income are not reset to zero.

The extinguishment of debt is typically classified as a reorganization item.

4.7 Parent’s accounting for subsidiary (bankruptcy emergence)

As noted in BLG 3.18, a reporting entity will often lose control and deconsolidate its subsidiary that files for bankruptcy, as the subsidiary becomes subject to the control of the Court during the bankruptcy proceedings. If the parent entity previously deconsolidated a subsidiary in bankruptcy, the parent entity should apply the provisions of ASC 805 in cases when it regains control of its previously deconsolidated subsidiary upon the subsidiary’s emergence from bankruptcy.
Chapter 5: Alternatives to reorganization—updated March 2023
5.1 Alternatives to reorganization: Chapter overview

The Chapter 11 process is intended to provide the debtor with a fresh start without the same level of debt or other liabilities. However, in many cases a debtor that enters bankruptcy does not emerge as a reorganized entity because liquidation of the entity or another path forward would best protect the interests of the various parties to the proceedings. For example, a sale of some or substantially all of the debtor's assets, or perhaps even liquidation of the enterprise, may realize the most value for the creditors. This chapter covers the sales of assets while in bankruptcy as well as quasi-reorganizations.

5.2 Sales of assets during bankruptcy

A sale of the debtor's assets can occur through a Court-approved auction under Section 363 of the Bankruptcy Code or as part of the debtor's reorganization plan under Section 1129 of the Bankruptcy Code. Section 363 sales and sales under the reorganization plan (Section 1129 sales) are further discussed in the following sections, along with the advantages and accounting implications of each type of sale.

5.2.1 Section 363 sales during bankruptcy

Section 363 of the Bankruptcy Code provides for sale of assets through a Court-supervised auction for an entity that has filed a bankruptcy petition under Chapter 11. These sales often involve the highest-valued assets or operations of the debtor entity. Any remaining assets, along with any remaining liabilities not assumed by the buyer, continue in the bankruptcy process. While the Bankruptcy Code outlines a process governing Section 363 sales, the terms and conditions of each transaction will differ.

A typical Section 363 sale begins with a decision that a sale through an auction process would be the most effective and efficient way to provide value to satisfy claims against the debtor. With Court approval, the debtor and its advisors identify a “stalking horse” acquirer with whom a purchase agreement is negotiated. A stalking horse can provide benefit to the sales process as the market for the assets to be sold is often thin and the stalking horse demonstrates to the market that there is indeed interest in the assets. The parameters of the solicitation and auction procedures are agreed upon and approved by the Court. This includes protections for the debtor and the stalking horse. The offer included in the stalking horse proposal becomes the initial bid for the subsequent auction process and outlines the terms of the transaction, such as the assets and liabilities to be included in the sale.

Question BLG 5-1

What are the advantages/disadvantages of using a stalking horse?

PwC response

A stalking horse benefits by setting the parameters for the Section 363 sale. This potential buyer usually sets the initial bid in the auction, the terms of the sale, and the assets and liabilities to be included in the transaction. Its bid serves as a minimum bid or benchmark in the marketing and sale process. The stalking horse often has more time for due diligence than competing bidders because it can perform its due diligence prior to the solicitation period imposed on other bidders. The “first mover” advantage also allows it to influence the pace and structure of the transaction and establish relationships with management and other key stakeholders of the debtor. However, since the stalking
Alternatives to reorganization

A stalking horse typically commits substantial resources to prepare its initial bid and the results of any due diligence are available to the other bidders, it faces the risk of performing a substantial amount of work without closing the deal. If another bidder is successful at auction, the stalking horse is often entitled to a breakup fee and reimbursement of its expenses.

Reporting entities should consider how stalking horse fees are structured, and how the fees may be impacted by the bankruptcy proceedings, to account for the fees. Such fees may be deemed subject to compromise and may be presented as a reorganization item by the debtor.

After a stalking horse is identified, a public auction is held by the debtor if at least one other bidder is identified. The Court-supervised auction continues until a winning bid is determined. Before approving the sale, the Court must find that the sale is in the best interests of the estate and its creditors, has a legitimate business justification, was negotiated in good faith and at arms’ length, and satisfies various tests and conditions for adequate assurance.

The winning bidder becomes the owner of the assets and liabilities. The winning bidder generally receives the assets free and clear of liens, but in turn accepts the assets “as is,” with no representations or warranties. The proceeds from the auction go to the bankruptcy estate to satisfy debtor obligations.

Advantages of a Section 363 sale include the following.

- Assets are generally transferred free and clear of liens and claims.
- The process provides greater flexibility in structuring the transaction. For example, a buyer may acquire only those operations of the debtor that are profitable and leave behind those that are not.
- The sale requires only the approval of the Court and is not subject to voting by the creditor committees. This can allow for a much shorter process in instances when creditors cannot block the sale. In addition, a Section 363 sale of all, or substantially all, of the assets of an entity does not require shareholder approval.
- In most cases, a sale under Section 363 is less expensive than an emergence of the debtor from Chapter 11.

At times, a reporting entity may file for bankruptcy protection and the news coverage may imply that the reporting entity will “emerge” from bankruptcy in an unusually short time, perhaps as little as 30 days. In most cases, the debtor is not actually emerging from bankruptcy in such a short period.

Rather, the debtor is usually selling a substantial majority of its assets, and the buyer is assuming some of the debtor’s liabilities, through a Section 363 sale. Proceeds from the sale are remitted to the debtor’s estate, and the debtor’s bankruptcy proceedings may continue for an extended period while any remaining assets are liquidated and liabilities are settled. In other cases, secured creditors may participate in a Section 363 sale through a credit bid.
Question BLG 5-2
What is credit bidding?

PwC response
In some cases, a qualified bidder’s primary competition in an auction may be the reporting entity’s existing secured creditors. When the value of the debtor’s assets does not exceed its secured debt (i.e., when the collateral is insufficient), the secured creditors are typically able to bid the full face value of their debt, subject to some limitations imposed by the Court. Private equity firms frequently accumulate a position in the secured debt of a bankrupt entity and actively use this as a tool to facilitate acquisition of a distressed entity’s assets via a Section 363 sale or in accordance with an entity’s plan of reorganization.

5.2.2 Sales under the reorganization plan during bankruptcy

In some instances, a debtor's reorganization plan may call for the sale of some of the reporting entity's assets to a third party in the bankruptcy proceedings. Section 1129 of the Bankruptcy Code governs this type of sale. The sale must be approved by the various creditor committees and confirmed by the Court as part of the reorganization plan.

A sale through the reorganization plan offers some of the same benefits as a Section 363 sale listed above—specifically, the ability to transfer assets free and clear of most liens and claims and, for the buyer, the ability to continue beneficial contracts while rejecting others.

The primary differences between the two types of sales are the different thresholds of approval required and, in most cases, the increased time and expense of going through the bankruptcy process. The higher degree of involvement and influence of the creditor classes generally makes a sale under the reorganization plan more complicated. That said, potentially valuable tax attributes of the debtor can be realized from such a sale if completed through a stock sale. Sales under Section 363 generally do not involve the acquisition of stock, so the debtor’s tax benefits rarely transfer to the acquiring entity.

5.2.3 Accounting for sales during bankruptcy

While in bankruptcy, the debtor’s accounting for a sale of certain of its operations is similar to a disposition by an entity not in bankruptcy, assuming the sale has been properly approved. The assets and liabilities included in the sale would be derecognized from the balance sheet, with any gain or loss recorded in the statement of operations when the sale has been approved by the Court. The accounting for the portion of the enterprise that remains after the sale would depend on how that portion is expected to be addressed in the bankruptcy. If the remaining portion of the entity is still expected to emerge as a reorganized entity, bankruptcy accounting would continue to be applied. However, in most Section 363 sales, the remaining assets after the sale are subsequently liquidated under Chapter 7 or Chapter 11 of the Bankruptcy Code. In these cases, a change to the liquidation basis of accounting for the remaining entity after the sale may be appropriate when the liquidation of the entity becomes imminent.

The disposal of some or all of a bankrupt entity's assets would be accounted for as a sale of nonfinancial assets or a sale of a business if the disposed assets constitute a business. In a sale of nonfinancial assets, the seller would apply the derecognition of nonfinancial assets guidance in ASC...
Alternatives to reorganization

610-20, *Gains and Losses from the Derecognition of Nonfinancial Assets*. Refer to PPE 6.2 for more information. In a sale of a business, the seller would apply the derecognition guidance in ASC 810-10-40, which requires the reporting entity to deconsolidate a subsidiary or derecognize a group of long-lived assets as of the date the reporting entity ceases to have a controlling financial interest. Refer to BCG 1.2 for more information on this determination.

### 5.3 Liquidations

In some cases, the parties in interest to the bankruptcy determine that the best option for the creditors is to liquidate the debtor. This liquidation may be performed under Chapter 7 or Chapter 11 of the Bankruptcy Code, and the process is subject to the Court's approval and overview, as described in BLG 1. Additionally, after a sale of substantially all of the reporting entity's assets, or a portion that represents a majority of the entity's value, the reporting entity should consider whether the adoption of the liquidation basis of accounting is necessary for the remaining entity. As mentioned earlier, the bankruptcy accounting guidance in ASC 852-10, *Reorganizations*, does not include entities in liquidation.

BLG 6 discusses accounting considerations for the liquidation basis of accounting in greater detail.

### 5.4 Quasi-reorganizations

A quasi-reorganization is a voluntary accounting procedure applied in rare circumstances by which a reporting entity with an accumulated deficit adjusts its accounts to obtain a “fresh start.” A quasi-reorganization (sometimes referred to as a “readjustment”) resembles a legally executed reorganization, but the procedure is accomplished without formal court proceedings and does not contemplate the creation of a new legal entity, a change in ownership, or a change in the rights and interests of creditors or shareholders.

#### 5.4.1 Accounting for quasi-reorganizations

A readjustment may be desirable in order for a reporting entity to pay dividends. Often, jurisdictions require an entity to have retained earnings in order to pay dividends. To prevent reporting entities from creating retained earnings through a mere recategorization of paid-in capital, certain legal and accounting requirements must be satisfied. A reporting entity may apply the accounting guidance in ASC 852-20 to effect a quasi-reorganization provided that it (1) discloses to its shareholders all of the facts and circumstances surrounding the nature of the distressed situation and the impact of the readjustment on its financial statement balances and (2) obtains formal shareholder approval prior to any readjustment. In addition, the legal approval of either the board of directors or shareholders is usually required, depending on the laws in the state of incorporation for US companies.

While ASC 852-20 discusses the accounting to be applied in a quasi-reorganization, it provides limited guidance surrounding the conditions under which a quasi-reorganization is permissible. ASC 852-20-25-2 states the general requirement that additional paid-in capital should not be used to relieve the income account of charges that would otherwise be made to the income account. However, one of the conditions specified in ASC 852-20-25-3 for when a quasi-reorganization is permissible is when “there may be no continuation of the circumstances that justify charges to additional paid-in capital.” In other words, the conditions that gave rise to the reporting entity’s deficit should be resolved such that the recurrence of losses giving rise to a future deficit is unlikely.
The SEC staff has provided additional conditions that should be met for a public company to perform a readjustment. In the SEC’s view, as described in ASC 852-20-S99, each of these conditions should be met to effect a quasi-reorganization.

- Retained earnings, as of the quasi-reorganization date, is exhausted.

- Upon consummation of the quasi-reorganization, no deficit exists in any surplus account (i.e., shareholders’ equity is positive).

- The entire procedure is made known to all persons entitled to vote on matters of general corporate policy and the appropriate consents to the particular transactions are obtained in advance in accordance with the applicable law and charter provisions.

- The procedure accomplishes, with respect to the accounts, substantially what might be accomplished in a reorganization by legal proceedings—namely, the restatement of assets in terms of present conditions as well as appropriate modifications of capital and capital surplus, to obviate the need, so far as possible, of future reorganizations of like nature.

Justification for quasi-reorganization accounting rests largely on circumstances that indicate that fresh-start reporting is appropriate. However, an entity emerging from a Chapter 11 reorganization that does not qualify for fresh-start reporting under ASC 852-10 should not use quasi-reorganization accounting at the time of its emergence.

The SEC staff has further interpretive guidance in ASC 852-20-S99-2 that addresses certain matters pertaining to the accounting for quasi-reorganizations, as summarized below.

- Elimination of an accumulated deficit by reclassifying amounts from capital surplus without satisfying all of the conditions set forth in ASC 852-20-S99 is prohibited. Therefore, a quasi-reorganization that does not involve a revaluation of balance sheet amounts is not allowed for public companies.

- Anticipated discretionary accounting changes should be adopted prior to or as part of the quasi-reorganization. Such changes are presumed to have been contemplated at the time of the quasi-reorganization and, as such, should be reflected as an integral part of the quasi-reorganization.

- Increases in the recorded values of specific assets (or reductions in liabilities) to fair value may be appropriate, provided such adjustments are factually supportable; however, the amount of such increases are limited to offsetting adjustments to reflect decreases in other assets (or increases in liabilities) to reflect their new fair values, such that a write-up of net assets in connection with a quasi-reorganization is prohibited.

- A quasi-reorganization cannot be reversed or “undone” in a subsequent period unless it is the correction of an error.

Nonpublic companies may want to effect a quasi-reorganization solely for the purpose of reclassifying an accumulated deficit to capital surplus. An AICPA Task Force prepared an issues paper on this topic (Issues Paper 88-1, dated September 22, 1988), which indicated that it would not be appropriate to combine paid-in capital with an operating deficit in the absence of a quasi-reorganization. In addition, ASC 852-20-15-3 does not apply to “quasi-reorganizations involving only deficit reclassifications.” As a result, this type of reclassification is not acceptable for nonpublic entities.
5.4.2 Balance sheet revaluation in quasi-reorganizations

In the absence of a formal reorganization, generally it is not acceptable to use quasi-reorganization accounting that would result in revaluation of balance sheet amounts involving a net write-off charged directly to equity. Prior to completing quasi-reorganization accounting, an entity should review the carrying amounts of its assets and recognize any impairments or write-downs otherwise necessary through profit and loss in accordance with the applicable guidance. When determining whether a further write-down to fair value is necessary, the determination of fair value should not be unduly conservative which would result in the overstatement of earnings subsequent to the quasi-reorganization. Only after the reporting entity is satisfied that it has appropriately recognized any impairments or other required asset adjustments through earnings and determined the fair values of its assets and liabilities would a net write-off directly to equity be permitted (assuming all other conditions to effect the readjustment have been met).

There may be instances when the write-up of assets to fair value is limited such that some assets may not be recorded at fair value after reflecting the quasi-reorganization. As noted in the SEC staff’s interpretive guidance in ASC 852-20-S99-2 (see Section 5.4.1), an entity’s net assets (i.e., shareholders’ equity) should not be increased as the result of a quasi-reorganization. As a result, when recording a readjustment, any excess fair value of an entity’s net assets over the book value of its shareholders’ equity would need to be systematically allocated to reduce the assets’ fair values so that shareholders’ equity is not increased.
Chapter 6: Liquidation basis of accounting —updated August 2021
6.1 **Liquidation basis of accounting: Chapter overview**

Most businesses are formed and managed with the intent of operating as ongoing entities. The preceding chapters in this guide generally focus on bankruptcy as a mechanism to allow a business with financial difficulties to reorganize so that it can be viable again as a going concern. However, a business can reach a point where the best result for its stakeholders is for the reporting entity to cease operations, liquidate its assets, and settle its obligations, with any remaining resources distributed to its owners. Liquidation may be a voluntary decision based on economic conditions, a defined event for a limited-life entity, or an involuntary act brought about by a reporting entity’s creditors, the Bankruptcy Court or other parties. Although the reasons vary, Figure BLG 6-1 represents the more common causes of liquidation.

**Figure BLG 6-1**

Reasons for liquidation

<table>
<thead>
<tr>
<th>Voluntary</th>
<th>Involuntary</th>
</tr>
</thead>
<tbody>
<tr>
<td>Business model can no longer be sustained</td>
<td>Chapter 7 bankruptcy</td>
</tr>
<tr>
<td>Purpose of the entity no longer relevant</td>
<td>Other creditor actions</td>
</tr>
<tr>
<td>Entity designed to operate for a finite period</td>
<td>Court-ordered liquidation</td>
</tr>
</tbody>
</table>

6.2 **Overview of the liquidation basis of accounting**

A liquidation is the process by which a reporting entity converts its assets to cash or other assets and settles its obligations with creditors in anticipation of ceasing all activities. During this process, cash and other assets are used to settle claims with any remaining assets distributed to the owners of the reporting entity.

Regardless of the reason for the liquidation, the need for relevant financial reporting remains critical even when a business is liquidating. The users of the financial statements of a business facing liquidation have different needs than investors in a going concern—a concept that was included in FASB Concepts Statement No. 1. In CON 1, the FASB commented on the needs of the financial statement user when liquidation is expected:

**Excerpt from CON 1, footnote 10**

Investors and creditors ordinarily invest in or lend to enterprises that they expect to continue in operation—an expectation that is familiar to accountants as the “going concern” assumption. Information about the past is usually less useful in assessing prospects for an enterprise’s future if the enterprise is in liquidation or is expected to enter liquidation. Then, emphasis shifts from performance to the liquidation of the enterprise’s resources and obligations. The objectives of financial reporting do not necessarily change if an enterprise shifts from expected operation to expected liquidation, but the
information that is relevant to those objectives, including measures of elements of financial statements, may change.

For a reporting entity facing liquidation, the operating results and cash flows of the going concern reporting entity are not particularly relevant. Instead, the outstanding reporting entity’s obligations and the cash or other resources on hand that can be used to satisfy those obligations are the information that is relevant for financial statement users. Accordingly, the measurement of assets and liabilities under the liquidation basis of accounting reflects the resources available to satisfy the obligations of the reporting entity as well as the expected settlement of those obligations. Historical reporting of results changes to a presentation of the resources that a liquidating reporting entity possesses and how those resources compare to its obligations. In many respects, this presentation is developed from, and is based on, the expectations of management as the liquidation process evolves.

When a reporting entity has adopted the liquidation basis of accounting, its financial statement requirements change from a balance sheet and statements of comprehensive income and cash flows to a statement of net assets in liquidation and a statement of changes in net assets in liquidation. These formats better reflect the needs of the users and are illustrated later in this chapter.

The FASB amended ASC 205, *Presentation of Financial Statements* in 2013 to clarify when a reporting entity should apply the liquidation basis of accounting, to provide principles for the measurement of assets and liabilities when in liquidation, and to establish financial reporting requirements once a reporting entity is in liquidation. ASC 205-30-20 defines “liquidation” as:

**Definition from ASC Master Glossary**

Liquidation: The process by which an entity converts its assets to cash or other assets and settles its obligations with creditors in anticipation of the entity ceasing all activities. Upon cessation of the entity’s activities, any remaining cash or other assets are distributed to the entity’s investors or other claimants (albeit sometimes indirectly). Liquidation may be compulsory or voluntary. Dissolution of an entity as a result of that entity being acquired by another entity or merged into another entity in its entirety and with the expectation of continuing its business does not qualify as liquidation.

The remainder of this chapter reflects the guidance under ASC 205-30. Refer to BLG 7.5 for disclosure requirements for a reporting entity in liquidation.

### 6.3 Who applies the liquidation basis of accounting

As noted in ASC 205-30-15-1, all reporting entities are in the scope of ASC 205-30 except for investment companies that are regulated under the Investment Company Act of 1940. The scope includes not-for-profit entities, nonpublic entities and the separate financial statements of employee benefit plans. Importantly, investment companies which are not regulated under the Investment Company Act of 1940 are in the scope but may not need to apply the guidance if their liquidation follows a plan specified at inception. See BLG 6.4.1 for further discussion of limited life entities.
6.4 When should the liquidation basis of accounting be adopted

The threshold for a reporting entity to adopt the liquidation basis of accounting is when liquidation is imminent, unless the entity follows a plan for liquidation which was specified at inception in its governing documents (e.g., its article of incorporation). When it is appropriate to apply the liquidation basis of accounting, it is not an election; a reporting entity should apply the guidance in ASC 205-30 to determine when a liquidation is considered imminent and, consequently, when the liquidation basis of accounting is required.

ASC 205-30-25-2

Liquidation is imminent when either of the following occurs:

a. A plan for liquidation has been approved by the person or persons with the authority to make such a plan effective, and the likelihood is remote that any of the following will occur:
   1. Execution of the plan will be blocked by other parties (for example, those with shareholder rights)
   2. The entity will return from liquidation.

b. A plan for liquidation is imposed by other forces (for example, involuntary bankruptcy), and the likelihood is remote that the entity will return from liquidation.

Whether liquidation is imminent should be carefully considered in light of the facts and circumstances and the actions of management regarding its plans for the reporting entity. Depending on a reporting entity’s bylaws or the laws of the state of incorporation, a voluntary plan of liquidation would ordinarily require approval by at least a simple majority of the shareholders. The liquidation basis of accounting should not be adopted in financial statements prior to such approval because until such approval, liquidation of the reporting entity is not “imminent.” If a plan of liquidation is imposed by other forces, the decision to liquidate is usually imposed by the Court and is outside the control of the reporting entity. In this case, it is remote that the reporting entity will return from liquidation and should adopt liquidation-basis accounting even if formal board approval is not obtained (i.e., in such a case, the decision to liquidate does not rest with the board). Management should consider seeking the guidance of legal counsel in determining when an involuntary liquidation is imminent.

ASC 205-30 does not consider the length of time the liquidation process could take as a factor in determining when the imminent threshold has been met. A reporting entity is required to adopt the liquidation basis of accounting as soon as its liquidation meets the definition of imminent, even if the actual liquidation event is 12 months or more in the future. However, when the liquidation process is expected to occur over a lengthy period that includes significant operating decisions, the reporting entity should carefully consider whether it has met the requirements of ASC 205-30-25-2.

Figure BLG 6-2 illustrates the determination of when the liquidation basis of accounting should be adopted.
Determination of when liquidation basis of accounting should be adopted

The liquidation basis is applied prospectively only from the day that liquidation becomes imminent, and so a reporting entity adopting the liquidation basis for the first time would not retrospectively adjust its historical financial statements. For practical reasons, the liquidation basis of opening account balances and adoption adjustments may be determined using a “convenience date.” A convenience date is a date shortly before or after the date the criteria for adoption are met (such as the beginning or end of the month or quarter in which the criteria are met) and is used when the impact is not quantitatively and qualitatively material to the reporting entity’s financial statements for all periods presented. Notwithstanding, the adoption date as presented on the statements and disclosed in the notes is usually the actual date the criteria were met. Generally, a convenience date should not cross a quarterly or annual reporting period. In instances when the imminent threshold is met after the balance sheet date but prior to the release of the financial statements, prior period financial statements should continue to be prepared on a going-concern basis and appropriate subsequent event disclosures, which may include pro forma financial data for the liquidation basis of accounting, should be provided.

The liquidation basis of accounting does not apply to a planned wind-down of a reporting entity’s activities that occurs over time where the legal entity will be kept active and may continue or increase operations with an improvement in the business climate. In such circumstances, the resolution by the board of directors or other governing body is usually not clear that liquidation is imminent and it may be difficult for the reporting entity to assert that the likelihood it will return from liquidation is remote.

Example BLG 6-1, Example BLG 6-2, Example BLG 6-3, Example BLG 6-4, and Example BLG 6-5 demonstrate circumstances when it may or may not yet be appropriate to adopt the liquidation basis of accounting. Example BLG 6-5 and Example BLG 6-6 illustrate the timing of adoption of the liquidation basis of accounting.
EXAMPLE BLG 6-1

A reporting entity that keeps its operating license intact

A mortgage origination entity’s management determines that the reporting entity will not process any new mortgages and will sell off its existing mortgage portfolio to third parties within the next six months. Following the distribution of the assets of the reporting entity, the business will not be dissolved as it holds a state mortgage license that the reporting entity’s parent wants to keep intact because it may begin to originate mortgages once market conditions improve.

Should the reporting entity adopt the liquidation basis of accounting?

Analysis

No. The mortgage origination entity should not adopt the liquidation basis of accounting because its liquidation is not considered imminent. The reporting entity would not be able to assert that its return from liquidation is remote since it is keeping its mortgage license intact and may resume operations if market conditions improve.

EXAMPLE BLG 6-2

A reporting entity that retains its legal charter

The board of directors of a research entity decides that because of the loss of a patent, the long-term viability of the reporting entity is in doubt. The board authorizes management to sell the reporting entity’s assets and settle all of its obligations, but there is no plan to make a final distribution of its assets or to dissolve its charter as the board explores other investment alternatives.

Should the reporting entity adopt the liquidation basis of accounting?

Analysis

No. The research entity should not adopt the liquidation basis of accounting because its liquidation is not considered imminent. While the reporting entity is disposing of its assets and settling its obligations, the entity’s charter is neither being dissolved nor are the proceeds from the liquidation being distributed. As the board explores other investment alternatives, the reporting entity is a going concern since it is considering using the sale proceeds to enter a new business. The reporting entity would not qualify for the liquidation basis of accounting until its board of directors approves further actions, such as a full dissolution of the reporting entity’s charter and distribution of any remaining proceeds to its shareholders.

EXAMPLE BLG 6-3

A reporting entity that files for Chapter 7 bankruptcy

Company A files a petition under Chapter 7 of the Bankruptcy Code, which involves an independent trustee taking over management of a reporting entity for purposes of liquidating the assets.

Is liquidation imminent for purposes of adopting the liquidation basis of accounting?
Analysis

It depends. The filing of the petition under Chapter 7 is a significant event, and in most cases would necessitate the adoption of the liquidation basis of accounting. Generally, when the filing of petition under Chapter 7 is voluntary, the plan would have been approved by the person or persons with the authority to make the plan for liquidation effective. When a reporting entity’s filing under Chapter 7 is involuntary, by definition the plan for liquidation has been imposed by other forces. Whether voluntary or involuntary, it is generally unlikely that a reporting entity filing under Chapter 7 will return from liquidation. Of course, a reporting entity’s facts and circumstances surrounding a Chapter 7 petition are unique, and so management should review the facts to ensure the criteria in ASC 205-30-25-2 are met prior to adopting the liquidation basis of accounting.

EXAMPLE BLG 6-4

A reporting entity that is not legally dissolved

Fund A is not registered under the Investment Company Act of 1940 and its governing documents do not specify a contractual life. Management of Fund A intends to liquidate Fund A’s investments whereby all investors will be fully redeemed and all expenses will be paid. Management does not intend to legally dissolve Fund A as the legal structure may be used in the future to start a new fund.

Should Fund A adopt the liquidation basis of accounting?

Analysis

It depends. Under ASC 205, liquidation, whether compulsory or voluntary, is the process by which a reporting entity converts its assets to cash or other assets and settles its obligations with creditors in anticipation of the reporting entity ceasing all activities. Upon cessation of the reporting entity’s activities, any remaining cash or other assets are distributed to the reporting entity’s investors or other claimants. A fund’s process to liquidate all assets, settle all debt, and distribute all net assets would most likely meet the definition of liquidation even if management does not legally dissolve the reporting entity after the liquidation process is completed.

However, in this scenario, an understanding of what the potential future use of the fund would be and the likelihood of such future use should be considered when determining whether adopting the liquidating basis of accounting is appropriate. A future likely use of the legal entity with similar or identical investment strategy to that of the recently liquidated fund should be considered as part of the analysis as to whether it is appropriate to adopt the liquidation basis of accounting.

EXAMPLE BLG 6-5

Timing of adoption of the liquidation basis of accounting

On June 30, 20X1, Company A was notified by its only customer that the customer will no longer order its product. Existing orders are expected to be completed by May 20X2. From July through December 20X1, Company A continued efforts to raise additional financing from venture capital groups and secure new customers. By December 15, 20X1, it was evident that these efforts would not be successful.

On March 1, 20X2, Company A obtains the required shareholder approval for a plan of liquidation that will be completed by May 20X2. Upon ceasing its operations, all employees will be terminated, and the
reporting entity’s assets will be liquidated to repay its creditors. Company A is preparing its December 31, 20X1, financial statements.

Should Company A adopt the liquidation basis of accounting in its December 31, 20X1, financial statements?

**Analysis**

No. In its December 31, 20X1 financial statements, Company A should apply the going-concern basis of accounting as liquidation is not considered “imminent” at that date. Under ASC 205-30, liquidation is considered “imminent” when either the plan has been approved by the person(s) with the authority to make such a plan effective, and the likelihood is remote that (1) execution of the plan will be blocked by other parties, and (2) the reporting entity will return from liquidation, or when a plan of liquidation is imposed by other forces and the likelihood is remote that the reporting entity will return from liquidation. Furthermore, the liquidation basis is applied prospectively only from the day that liquidation becomes imminent, and so a reporting entity adopting the liquidation basis for the first time would not retrospectively adjust its historical financial statements.

In this fact pattern, Company A’s liquidation does not meet the imminent threshold until the required shareholder approval is obtained. Although going-concern accounting is utilized as of December 31, 20X1, given the significance of the subsequent event and the pending change in the basis of accounting, it may be necessary to provide a pro forma statement of net assets in liquidation giving effect to the change to liquidation basis of accounting as if it had occurred on the date of the balance sheet. See FSP 28.6.3.12.

**EXAMPLE BLG 6-6**

**Use of convenience date**

The criteria for liquidation being imminent are met under ASC 205 on October 29, 20X1.

Can liquidation basis of accounting be adopted by the reporting entity on October 31, 20X1?

**Analysis**

Assuming the reporting entity reports annually on December 31, 20X1, it would prepare its “going concern” financial statements for the January 1 through October 28, 20X1 period and its liquidation basis financial statements for the October 29 to December 31, 20X1 period. Alternatively, any activity between October 29 and 31 may be included in the October 28, 20X1 financial statement, if, after considering the impact of using a convenience date together with the effect of all other identified errors, the financial statements (all periods presented) are not considered to be materially misstated.

**6.4.1 Limited life entities in the liquidation basis of accounting**

ASC 205-30-25-3 describes additional considerations for limited life entities. A reporting entity with a contractually-limited life which liquidates its assets in accordance with the plan specified at the reporting entity’s inception as outlined in its governing documents would not adopt the liquidation basis of accounting upon commencing liquidation. Limited life entities apply liquidation accounting only in the event of an unplanned liquidation. Therefore, when the final approved plan of liquidation differs from the plan specified at inception, the liquidation basis of accounting may be applicable.
When a limited life entity decides to liquidate its assets at a different point in time than that contemplated in its governing documents (which could be upon a certain date, event, milestone, etc.), but at amounts commensurate with fair value, the liquidation is not considered unplanned. Conversely, when a limited life entity is forced to liquidate its assets in exchange for consideration which is not commensurate with the fair value of its assets, it is presumed that the reporting entity’s liquidation does not follow its plan of liquidation as laid out at its inception. In such a scenario, a reporting entity with a contractually-limited life would adopt the liquidation basis of accounting on the date that its unplanned liquidation becomes imminent.

Example BLG 6-7, Example BLG 6-8, and Example BLG 6-9 illustrate considerations for the application of the liquidation basis of accounting for a limited life entity.

**EXAMPLE BLG 6-7**

Applying the liquidation basis to a limited life entity

Company B’s governing documents specify that its contractual life will end in year ten. Company B is not registered under the Investment Company Act of 1940. On March 11 of year six, Company B’s board of directors determined that the reporting entity would not be able to meet its debt obligations and voted to begin liquidating the reporting entity earlier than planned. Company B required approval from Company C, a third party, to make its plan of liquidation effective. Company B obtained approval from Company C on April 10 of year six. No other parties could block the execution of the plan of liquidation, and the likelihood that Company B would return from liquidation was remote. Under the plan of liquidation, Company B anticipated that it would not have sufficient time to sell its assets in exchange for consideration that would approximate the fair value of those assets.

Should Company B adopt the liquidation basis of accounting in its financial statements?

*Analysis*

Yes. Considering Company B will liquidate its assets for consideration that is not commensurate with fair value, Company B should begin preparing its financial statements using the liquidation basis of accounting as of April 10 of year six, which is the date that the reporting entity obtained all of the approvals required to make its plan of liquidation effective.

**EXAMPLE BLG 6-8**

Applying the liquidation basis to a limited life entity

At its inception, Partnership A has a contractually-limited life whereby its assets will be liquidated at the end of its tenth year. Partnership A is not registered under the Investment Company Act of 1940. In year seven, due to favorable market conditions, Partnership A’s general partner, having the authority to do so, approves a plan to immediately liquidate all of Partnership A’s assets at fair value. The partnership will not return from liquidation.

Should Partnership A adopt the liquidation basis of accounting in its financial statements?

*Analysis*

No. Even though Partnership A will liquidate its assets before the end of its contractual life, which was not anticipated at its inception, it would not adopt the liquidation basis of accounting because the sale
of its assets are expected to be sold at a price commensurate with fair value. A reporting entity with a contractually-limited life would only adopt the liquidation basis of accounting if it has an unplanned liquidation event at amounts not commensurate with fair value.

**EXAMPLE BLG 6-9**  
Applying the liquidation basis to a limited life entity

At its inception, Partnership A has a contractually-limited life whereby its assets will be liquidated at the end of its tenth year. Partnership A is not registered under the Investment Company Act of 1940. Given the market conditions at the end of year ten, the advisor decides to extend the life of the fund for an additional year as provided for in the governing documents.

Should Partnership A adopt the liquidation basis of accounting in its financial statements?

*Analysis*

Generally, no. The governing documents for many private equity and venture capital funds allow the advisor/general partner to extend the life of the fund for a limited number of consecutive one-year periods if required for an orderly wind-down. Generally, the exercise of these provisions is not a “difference” in the plan of liquidation requiring the adoption of liquidation basis of accounting. Rather, these provisions are included in the governing documents to allow a fund manager some latitude to consider market conditions at or near the scheduled termination date. Relatively minor delays or accelerations in end dates for limited life entities do not require the adoption of liquidation basis of accounting unless assets are not expected to be liquidated at fair value.

### 6.4.2 *Parent and subsidiary relationships (liquidation basis)*

Reporting under the liquidation basis of accounting is applicable only for the reporting entity in liquidation. Thus, consolidated financial statements for a reporting entity with a subsidiary in liquidation should be prepared on a going concern basis even if the subsidiary has adopted the liquidation basis of accounting for its stand-alone financial statements.

A reporting entity with a subsidiary in liquidation should assess if it still has control over the subsidiary. As discussed in BLG 3.18, consolidation of a majority-owned subsidiary is precluded where control does not rest with the majority owner. When the subsidiary is in a forced liquidation, such as a Chapter 7 bankruptcy filing, applying the guidance in ASC 810 will often result in the parent deconsolidating the subsidiary in liquidation. If the subsidiary’s liquidation is voluntary and the reporting entity retains control of the subsidiary, the reporting entity should consider other applicable accounting guidance, such as held-for-sale classification and discontinued operations presentation, if applicable, to properly reflect the subsidiary in its consolidated financial statements.

Following the guidance in ASC 205-30-20, a reporting entity that becomes wholly-owned by a related entity or is merged into a related entity in a common control transaction is not considered a liquidation when there is an expectation to continue the original reporting entity’s business activities. Similarly, an intended spin or split off of a subsidiary does not represent a liquidation from the perspective of the disposing reporting entity. See BCG 7 for guidance on accounting for common control transactions. Question BLG 6-1 discusses the application of the liquidation basis of accounting in a reporting entity’s consolidated financial statements.
Question BLG 6-1

In its consolidated financial statements, should Company Y apply the liquidation basis of accounting to the specific assets and liabilities related to a portion of its operations which will be liquidated in the coming months?

PwC response

No. The liquidation basis of accounting is applied at the reporting entity level, not for specific portions of a consolidated group. However, Company Y should look to the guidance related to the accounting for impairments, disposals, and discontinued operations, as appropriate.

If the specific assets and operations being liquidated represent a legal subsidiary for which stand-alone financial statements are prepared, Company Y should consider whether the subsidiary's financial statements should be prepared on the liquidation basis of accounting. If the conditions in ASC 205-30-25-2 for a liquidation to be imminent are met at the subsidiary level, the subsidiary should adopt the liquidation basis of accounting in its stand-alone financial statements even though the parent company's financial statements continue to be prepared on a going concern basis.

6.5 Liquidation basis accounting model

Under the liquidation basis of accounting, the emphasis shifts from reporting about the reporting entity’s economic performance and position to reporting that focuses on the amount of cash or other consideration that an investor might reasonably expect to receive upon liquidation. The financial statements of a reporting entity applying the liquidation basis should reflect the amount of cash or other consideration that an investor might reasonably expect to receive after the reporting entity’s assets have been liquidated and liabilities have been settled. The recognition and measurement principle for a reporting entity which has adopted the liquidation basis of accounting may include items which the reporting entity did not previously recognize on its going concern balance sheet, such as internally developed intangible assets. If such assets are expected to generate sales proceeds, the assets should be recognized upon the reporting entity’s adoption of the liquidation basis.

Prior to adopting the liquidation basis of accounting, a reporting entity should consider whether any adjustments to its assets and liabilities are necessary while preparing going concern financial statements. In the periods prior to the adoption of the liquidation basis of accounting, assets, including goodwill, intangible assets, and long-lived assets, should be evaluated for impairment under the applicable standards. Generally, financial statements after the adoption of the liquidation basis of accounting would not reflect goodwill because it usually does not have any realizable value in a liquidation. See BLG 2 for additional detail.

6.5.1 Valuation considerations in the liquidation basis of accounting

For a reporting entity in liquidation, the valuation premise used to prepare going concern financial statements may not always be appropriate. While ASC 820, Fair Value Measurements and Disclosures, requires the use of market participant assumptions and the consideration of the most advantageous market when estimating fair value, the liquidation basis is developed from the reporting entity’s point of view and is based on the expectations of its management. The definition of fair value under ASC 820 is “the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.” This approach may not be
appropriate for a reporting entity in liquidation because the process of liquidation can involve
distressed or forced sales of assets without a sufficient period to market the assets or wait for an
illiquid or depressed market to recover. In some cases, a fair value measurement may be appropriate
to approximate the amount of cash or other consideration that a reporting entity expects to collect, but
ASC 205-30 does not presume that a fair value measurement would be applied to measure all assets.

The more uncertain the future liquidation value becomes (e.g., due to the date of disposition being
uncertain or because liquidation of the investment portfolio will not occur in the near term), the more
relevant the current fair value of the investment position may become for purposes of reporting under
the liquidation basis of accounting. However, discounting of cash flows from the expected
exit/disposal date to the balance sheet date to reflect the time value of money is prohibited under ASC
205 when determining the liquidation values of assets and liabilities. Accordingly, management must
eliminate the time value of money when measuring the liquidation value of investments such as
private equity securities, structured products, or other distressed fixed income securities. The use of a
discounted cash flow model to determine liquidation value, however, may be appropriate if such
model results in a value that represents a best estimate for those cash flows expected to be received at
the future disposition date. Management should clearly disclose in the notes to the financial
statements its bases for determining the liquidation values of investments.

Example BLG 6-10 highlights the valuation concepts applied when measuring the liquidation value of
investments.

**EXAMPLE BLG 6-10**

Determining liquidation value

A fund has adopted the liquidation basis of accounting as of January 1, 20X1. The fund holds a zero-
coupon debt investment for which management uses a discounted cash flow model to estimate
liquidation value at an expected date of sale two years out from the current balance sheet date.

Would it be appropriate to apply a valuation model that effectively discounts the expected proceeds in
determining the liquidation value of the private equity investment?

**Analysis**

ASC 205 does not permit the use of discounted cash flows to measure the liquidation value of an asset
at the reporting date. However, it would be acceptable to use a discount rate that reflects the risk (e.g.,
collection risk, market risks, etc.), to measure the value expected to be collected at a future disposition
date.

**6.5.2 Use of NAV as a practical expedient (liquidation basis)**

When applying the liquidation basis of accounting, careful consideration should be given to the use of
NAV as a practical expedient for measuring investments in funds. The practical expedient is allowable
only if, among other requirements, the investee fund is following the ASC 946, *Financial Services -
Investment Companies*, accounting model and if a sale at an amount that approximates NAV is
probable (based on criteria in ASC 820-10-35-62).
If a fund is reporting under the liquidation basis of accounting, the fund is not reporting pursuant to ASC 946 or valuing its investments at fair value pursuant to ASC 820. Therefore, the NAV practical expedient is not available to be used for the measurement of an investment in a fund in liquidation.

If a reporting entity is reporting under the liquidation basis of accounting and intends to sell an investee fund in the secondary market instead of redeeming or receiving distributions from the underlying investee fund, the investee fund’s net asset value may not be the best estimate of liquidation value. In addition, any restrictions on exit would need to be considered when determining liquidation value.

6.5.3 Accounting for assets under the liquidation basis of accounting

Assets of the reporting entity are measured at the estimated amounts of cash or other consideration it expects to collect, which may be different from fair value. ASC 205-30-25-4 requires recognition of assets that a reporting entity expects to sell in liquidation or use to settle liabilities that are not permissible for recognition under non-liquidation basis GAAP. Trademarks, which may have no basis in a reporting entity’s going concern financial statements but would be recorded at liquidation value, are an example of such assets and may be recognized in the aggregate.

Assets presented under the liquidation basis are not depreciated, and accumulated depreciation is not presented. Impairment and other methodologies for adjusting asset values under a going concern basis are not relevant under the liquidation basis. In theory, since assets are measured at the amount of cash the reporting entity expects to collect upon sale, gains or losses on asset dispositions would not be expected in liquidation-basis accounting financial statements.

Deferred charges and other assets that will not be converted to cash or other considerations (e.g., deferred financing costs, prepaid expenses) should be written off at the date of adoption of liquidation basis of accounting.

The adoption of the liquidation basis of accounting might create adjustments that seem unusual in comparison with the financial statements of going concern entities. For example, a going concern manufacturing entity may present equipment classified as held and used at a carrying value of $400,000, but on a liquidation basis this equipment would be presented based on its estimated liquidation proceeds of only $200,000. The decrease in carrying value would be an effect of the adoption of the liquidation basis of accounting. On the other hand, a building may be presented at a carrying value of $1 million on a going concern basis but valued at $1.2 million based on its estimated proceeds under the liquidation basis. The recorded amount for the building would be written up when adopting the liquidation basis of accounting.

Example BLG 6-11 illustrates the concepts associated with measuring assets under the liquidation basis of accounting.

EXAMPLE BLG 6-11

Recognition of future income expected on investment in debt security

A nonregistered investment company with a December 31 year end has one fixed income investment with a 10% coupon rate paid annually. The investment company determines that liquidation is imminent on January 1, 20X1 and will likely dispose of its investment on December 31, 20X1. On January 1, 20X1, the investment company estimates the sales proceeds (net of selling costs) it expects
to receive on the disposition date (December 31, 20X1) as $100, which is considered the liquidation
value. The fair value on January 1, 20X1 is $95.

The investment company also concludes that it has a reasonable basis to estimate this security’s
interest income through the end of liquidation and accrues, as of January 1, 20X1, the undiscounted
interest coupon payment of $10 expected to be received during the period from January 1, 20X1 to
expected disposition on December 31, 20X1.

How should the investment company measure and record its fixed income investment upon adoption
of the liquidation basis of accounting?

*Analysis*

Upon adoption of the liquidation basis of accounting on January 1, 20X1, the investment company
would measure its total position (investment and accrued interest income) at the amount of cash it
expects to receive during the period through liquidation on December 31, 20X1 as $110 (the $10
interest coupon payment plus the $100 of expected sales proceeds from disposition of the fixed income
investment). The fair value of $95 is not directly considered in determining liquidation value nor
recorded in the financial statements.

### 6.5.4 Accounting for liabilities under the liquidation basis of accounting

ASC 205-30-25-5 and ASC 205-30-30-2, respectively, requires a reporting entity in liquidation to
continue to recognize and measure its liabilities in accordance with the recognition and measurement
provisions of other accounting standards that would otherwise apply to those liabilities. Certain
events that may occur in connection with a liquidation, such as a covenant violation or a troubled debt
restructuring, have specific accounting guidance that a reporting entity should consider even when
applying the liquidation basis of accounting. Further, liabilities of specified, contractual amounts
should not be written down to their estimated settlement amounts until the liabilities are legally
settled. However, liabilities without contractually specified amounts that are measured based on
estimates of settlement amounts and timing should be adjusted to incorporate all changes to
assumptions which are impacted by the reporting entity’s decision to liquidate.

For example, a reporting entity may have an asset retirement obligation (ARO) for which, prior to
applying the liquidation basis, it estimated would be settled in five years. Upon adopting the
liquidation basis of accounting, the reporting entity now expects the ARO will be settled in three
months. The reporting entity should re-measure the ARO on the date it adopts the liquidation basis of
accounting to incorporate its updated estimate of the settlement date of the liability. However, it
should not reduce the estimated cash flows inherent in the ARO estimate for any anticipated
forgiveness until such liability is legally forgiven.

### 6.5.5 Accounting for disposal costs under the liquidation basis of accounting

Upon adoption of the liquidation basis, a reporting entity should accrue the estimated disposal costs of
the assets it expects to sell in liquidation in accordance with ASC 205-30-25-6. The expected disposal
costs should be reported in the aggregate separately from the carrying amounts of the related assets.
The measurement of a reporting entity’s estimate of its disposal costs for the liquidation should be
made on an undiscounted basis.
6.5.6  Accounting for future income and costs under the liquidation basis of accounting

On the date it adopts the liquidation basis, as stated in ASC 205-30-25-7, a reporting entity should accrue all future income it reasonably expects to earn and costs it reasonably expects to incur, including those from any remaining operating activities, until its liquidation is complete. Expected income and costs should be measured on an undiscounted basis in accordance with ASC 205-30-30-3. Because the purpose of liquidation basis financial statements is to provide users with information regarding the resources and obligations of the reporting entity, accruing liquidation and other costs when liquidation is imminent provides an improved perspective on the resources that will be available to satisfy the reporting entity’s obligations. That is, the expensing of such costs as incurred, although generally appropriate for going concern entities, would be inconsistent with the purpose of liquidation basis financial statements.

For example, on the date it adopts the liquidation basis, a reporting entity may expect to continue to employ five staff to assist with wind-down activities. Its liquidation is expected to last three months. On the adoption date, the reporting entity should accrue three months of payroll and related costs for the five employees, as long as it has a reasonable basis to estimate the anticipated costs.

In situations where a reporting entity is not able to reasonably estimate the amount of future costs it expects to incur or income it expects to earn, it would expense costs as incurred and recognize income as earned until such time it has sufficient information to make such an estimate.

The financial statements should include disclosure of the assumptions used with regard to the accrual of fees (and all other significant income or expense) and the related estimation uncertainty, if any.

Example BLG 6-12 illustrates the concepts associated with accounting for future income and costs under the liquidation basis of accounting.

**EXAMPLE BLG 6-12**

Recognition of future expenses expected to be incurred in a fund

A nonregistered fund with a management fee and incentive fee structure in place adopts the liquidation basis of accounting. Should the fund accrue expenses related to the management and incentive fee arrangement?

*Analysis*

Oftentimes, incentive fees and, sometimes, management fees of an investment manager are waived by the investment manager during the liquidation period. However, if the fee arrangements are not waived, the fees should be accrued when there is a reasonable basis for estimation. When fees are not estimable for the entire period of liquidation, in most instances at least the fees to be earned in the near term can be estimated and, if so, should be accrued by the fund.

A liquidation basis adoption adjustment for fee arrangements that are not waived is expected. As such, management should carefully consider facts and circumstances surrounding fee arrangements and evaluate whether an accrual for incentive and management fees is necessary upon the adoption of the liquidation basis of accounting and subsequently during liquidation.
The treatment of the various financial statement elements under the liquidation basis of accounting is summarized in Figure BLG 6-3.

**Figure BLG 6-3**  
Impact on financial statement balances of adopting the liquidation basis of accounting

<table>
<thead>
<tr>
<th>Financial statement element</th>
<th>Accounting</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets</strong></td>
<td>Estimated amount of cash expected to be collected in disposition, including assets not previously recognized (e.g., internally developed trade names that can be sold)</td>
</tr>
<tr>
<td><strong>Liabilities</strong></td>
<td>Continue to recognize and measure liabilities in accordance with the provisions of other accounting standards that would apply to those liabilities, incorporating any revised assumptions that are a result of the reporting entity’s decision to liquidate</td>
</tr>
<tr>
<td><strong>Disposal costs</strong></td>
<td>Accrue estimated disposal costs of assets in the aggregate, separately from those assets</td>
</tr>
<tr>
<td><strong>Anticipated future income and costs</strong></td>
<td>Accrue all expected future income and costs that are expected to be earned or incurred through the liquidation date, including interest income and expense; such income and costs should only be accrued if and when the reporting entity has a reasonable basis for estimation</td>
</tr>
<tr>
<td><strong>Deferred charges and other assets that will not be converted to cash or other considerations (e.g., deferred financing costs, prepaid expenses)</strong></td>
<td>Write off at the date of adoption of liquidation basis of accounting</td>
</tr>
</tbody>
</table>

At each reporting date after adopting the liquidation basis of accounting, a reporting entity should continue to remeasure its assets, liabilities, and accruals for disposal costs and other income and costs using the same measurement principles as it followed on the date it adopted the liquidation basis.

**6.6 Financial reporting — liquidation basis of accounting**

For a reporting entity that has adopted the liquidation basis of accounting, the financial statements consist of a statement of net assets in liquidation and a statement of changes in net assets in liquidation.

Details of equity accounts ordinarily are not shown on the statement of net assets in liquidation. However, presentation of the amounts expected to be distributed to different shareholder classes may be appropriate when a reporting entity has a complex capital structure or noncontrolling interests exist. Although not addressed in ASC 205-30, when a reporting entity’s liabilities exceed its assets in liquidation, we believe it is appropriate for the statements to be titled “statement of net liabilities in liquidation” and “statement of changes in net liabilities in liquidation.”
In general, the statement of net assets in liquidation, which replaces the balance sheet, is presented in an unclassified format with the excess of assets over liabilities shown as a single amount designated “net assets in liquidation” (or vice versa if liabilities exceed assets). In the example financial statements within Figure BLG 6-4, “accrued liquidation costs” captures the expected disposal costs of the reporting entity’s assets and estimated future other income and costs through the end of the liquidation process.

**Figure BLG 6-4**
Example financial statements – liquidation basis of accounting

<table>
<thead>
<tr>
<th>Liquidation Industries</th>
</tr>
</thead>
<tbody>
<tr>
<td>Consolidated statement of net assets in liquidation</td>
</tr>
<tr>
<td>At December 31, 20X1 (in thousands)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Account</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash and cash equivalents</td>
<td>$ 450</td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>1,400</td>
</tr>
<tr>
<td>Inventory</td>
<td>720</td>
</tr>
<tr>
<td>Property, plant, and equipment</td>
<td>4,560</td>
</tr>
<tr>
<td>Accounts payable and accrued expenses</td>
<td>(180)</td>
</tr>
<tr>
<td>Accrued liquidation costs</td>
<td>(880)</td>
</tr>
<tr>
<td><strong>Net assets in liquidation</strong></td>
<td><strong>$ 6,070</strong></td>
</tr>
</tbody>
</table>

The statement of changes in net assets in liquidation includes summarized increases and decreases in net assets in liquidation, such as liquidating dividends, and changes in estimates of assets, liabilities, and changes in the accruals for disposal or other costs or income to reflect the actual or estimated change in carrying value during the period liquidation is imminent.
### Liquidation Industries

Consolidated statement of changes in net assets in liquidation

For the period of October 1, 20X1 to December 31, 20X1 (in thousands)

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount (in thousands)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net assets in liquidation as of October 1, 20X1</td>
<td>$10,020</td>
</tr>
<tr>
<td>Liquidation dividend</td>
<td>(3,000)</td>
</tr>
<tr>
<td>Remeasurement of assets and liabilities</td>
<td>(950)</td>
</tr>
<tr>
<td><strong>Net assets in liquidation as of December 31, 20X1</strong></td>
<td><strong>$6,070</strong></td>
</tr>
</tbody>
</table>

The FASB did not provide specific guidance on whether financial statements should be presented for the period of time that preceded the determination that liquidation is imminent. However, consideration should be given to any regulatory requirements applicable to the reporting entity.

ASC 205-30-45-2 clarifies that the statement of changes in net assets in liquidation should only present those changes that occurred during the period since liquidation became imminent. Accordingly, the accounting adjustments to apply the liquidation basis should not be reflected in the initial statement of changes in net assets in liquidation. If a reporting entity presents financial statements for the period prior to liquidation becoming imminent (i.e., when it is still a going concern), the adjustments to adopt the liquidation basis of accounting should not be recognized in those financial statements since the adjustments are not related to the going concern period. While not recognized, generally it would be appropriate for a reporting entity to disclose the changes resulting from adopting the liquidation basis of accounting in the notes to the financial statements that include the date liquidation became imminent.

When financial statements for periods prior to adopting the liquidation basis are presented, the statement of net assets in liquidation and statement of changes in net assets in liquidation should be presented using a black-line to denote the different bases of accounting. BLG 4.5.1 discusses the black-line presentation of financial statements in the context of entities emerging from bankruptcy. This concept is the same for entities adopting the liquidation basis of accounting. Alternatively, a reporting entity in liquidation could separately present its financial statements prepared while in liquidation on the liquidation basis of accounting and its financial statements prior to the liquidation basis of accounting being adopted presented on a going concern basis.
6.7 Other investment company considerations (liquidation basis)

ASC 205 requires that the financial statements prepared on the liquidation basis of accounting consist of, at a minimum, (1) a statement of net assets in liquidation and (2) a statement of changes in net assets in liquidation. Further, a nonregistered investment company’s statement of net assets in liquidation would include a schedule of investments in liquidation. In circumstances when the liquidation basis of accounting has been adopted, financial statement headings should disclose the status of the reporting entity. This would generally be "in liquidation." However, entities such as private funds that are domiciled in the Cayman Islands may wish to use another term, such as "prepared on the liquidation basis of accounting," as the term "in liquidation" has a distinct legal meaning in the Cayman Islands.

Other financial statements, financial highlights, and schedules are not required to be presented. However, a reporting entity may present additional financial statements or disclosures if these items are useful in understanding the cash the reporting entity expects to collect and the amount the reporting entity is obligated or expects to be obligated to pay during the course of liquidation. Information that contradicts the liquidation basis financial information or has the potential to confuse or mislead users of the financial statements should not be included in liquidation basis financial statements.

The presentation of certain voluntary information, including additional core financial statements and financial highlights, has an increased potential to confuse or mislead financial statement users. For example, because the liquidation basis of accounting is intended to reflect all future cash receipts and expenditures, a statement of operations during a liquidation period would not be expected to reflect operations of the fund the same way those operations were reflected before a liquidation period. In general, a statement of operations during a liquidation period would not be expected to contain any meaningful activity when the provisions of ASC 205 have been applied appropriately. Significant operations during a liquidation period may indicate that certain balances (e.g., liquidation costs) were not estimated with sufficient accuracy at the initial adoption of ASC 205.

Likewise, because the objective of liquidation basis accounting is fundamentally different than the objective of going concern accounting, financial highlights based on liquidation basis accounting have an increased risk of being misunderstood by financial statement users. For example, because the total return computation formula used by asset managers assumes reinvestment of dividends, implausible results sometimes occur when the formula is applied to interim distributions made by a fund in liquidation since active investment operations have ceased and “reinvestment” implies simply buying more of the remaining investments in the fund. Further, as a reporting entity nears complete liquidation and its capital dwindles, the denominators for many ratios do not provide meaningful results. Also, it may not be appropriate to annualize the net investment income and expense ratios when the reporting entity has adopted the liquidation basis of accounting as liquidation costs have been accrued through final liquidation (which may take longer than a year). Even if the liquidation basis values to be reported are expected to approximate values that would have been reported in non-liquidation basis financial statements (i.e., as if the fund were not in liquidation), the potential for misunderstanding still exists.

For these reasons, the liquidation basis financial statements of private funds generally should not include financial statements or financial highlights that are not required by ASC 205.
Chapter 7: Common disclosures for entities in bankruptcy or liquidation—updated July 2021
7.1 Common bankruptcy or liquidation disclosures: Chapter overview

The authoritative literature for bankruptcy accounting, ASC 852-10, Reorganizations, contains little specific guidance on the disclosures that should be included in the financial statements of a reporting entity in bankruptcy. Much of the disclosure found in financial statements today for companies involved in a bankruptcy has been developed in practice over the years. The listing in BLG 7.2, while not exhaustive, includes the basic disclosures that might be expected for a typical bankruptcy filing. Companies reporting during bankruptcy should consider reviewing SEC filings of companies within their industry that have been involved in recent bankruptcy proceedings.

The authoritative guidance for required disclosures for entities that have adopted the liquidation basis of accounting is more clearly defined, as described in ASC 205-30, Liquidation Basis of Accounting.

7.2 General disclosures about the bankruptcy process

The following disclosures should be considered in a reporting entity’s financial statements during a period of financial distress that may result in a bankruptcy filing:

- A description of the events leading up to and during bankruptcy and a summary of the impacts and timeline of the bankruptcy proceeding:

  This basic information regarding the case should include the filing date, the subsidiaries included in the filing, the jurisdiction where the case is being heard, the petition number, and other information that would allow the reader to gain an understanding of the proceedings or where such information can be located.

- A description of key events that have occurred during the reporting period or prior to the issuance of the financial statements:

  These might include key hearings before the Court (such as agreements allowing the reporting entity to pay certain creditors), agreement reached with creditors, decisions made by management as a result of the bankruptcy, or other events that would be of interest to the user of the financial statements. As the filings and related information are publicly available, the disclosures included in the financial statements should be consistent with that made available by the Court.

- Although not required to be included in the disclosures specifically related to the bankruptcy, the impact of the filing on other areas of the financial statements would likely be required to be disclosed under other applicable GAAP. For example, debt covenant violations, impairments of intangible or long-lived assets, going concern considerations, and other accounting matters should be disclosed as appropriate.

- The status of any debtor-in-possession financing and exit financing, including the terms of the debt and the status of Court approval should be disclosed.

- While under debtor-in-possession status, the financial statements should be labeled as such.
7.3 **Disclosure during the bankruptcy period**

In the period following the filing of the bankruptcy petition, and before emergence, ASC 852-10-45 and ASC 852-10-50 require the following incremental disclosures for entities in bankruptcy:

- The effects of the application of ASC 852 on the financial statements of the debtor, specifically the required disclosures for the following significant items:
  - The basis for determining what accounts are included within liabilities subject to compromise and the significant items within that category
  - The basis for determining what items are included within reorganization items and the significant items within that category

- The condensed combined financial statements of the entities involved in the bankruptcy if the consolidated financial statements include one or more entities in bankruptcy and one or more entities not in bankruptcy. These should include statements of operations and cash flows covering the period while in bankruptcy and a balance sheet as of the date of the consolidated balance sheet.

- Details of operating cash receipts and payments resulting from the reorganization if the statement of cash flows is prepared using the indirect method. Such details may be included in the notes to the financial statements or disclosed in a supplementary schedule to the statement of cash flows.

- Claims that are not subject to reasonable estimation under ASC 450-20, *Contingencies*. In addition, companies in bankruptcy often receive claims from creditors that are not valid. In this situation, the amounts of the total claims submitted, the process for considering those claims, and the amount of these claims that are expected to be rejected should be disclosed. If the reporting entity has not finished its assessment of valid claims, it should clearly disclose this fact as well as the amount of claims which have not yet been assessed.

- The difference between reported interest expense and the amount that would have been accrued absent the limitations for accruing interest under bankruptcy law. This can be included on the face of the statement of operations (see BLG 3.9) or in the notes to the financial statements. Additionally, disclosure of interest income earned by a reporting entity in bankruptcy that would not have been earned except for the proceedings is also required to be reported within reorganization items.

- Earnings per share if required by ASC 260, *Earnings Per Share*. If it is probable that the reorganization plan will call for the issuance of common stock or common stock equivalents, thereby diluting current equity interests, that fact must be disclosed.

- The status of the plan of reorganization and voting by the creditors.
7.4 Disclosure upon emergence and adoption of fresh-start reporting

Upon emergence from bankruptcy, a reporting entity should consider the following disclosures as outlined in ASC 852-10-50:

- Upon confirmation of the plan of reorganization, disclosure of the confirmation and effective dates. In addition, the general terms of the confirmed plan should be included with sufficient detail to provide the reader with a summary of how the plan of reorganization addresses the various creditor classes, how the reporting entity will be restructured under the terms of the plan, the existence and terms of any other arrangements (such as exit financing, warrants, and contingencies) that will be resolved in the periods following emergence.

- A reconciliation of the impact on each balance sheet account from the reorganization and application of fresh-start reporting in a tabular format with the following columns: predecessor company balance sheet, effects of reorganization plan, fresh-start adjustments, and successor company balance sheet (the “fresh-start table”), and footnote descriptions of the significant reorganization and fresh-start adjustments within the fresh-start table (see Example BLG 4-2). The descriptions should provide sufficient information supporting the balances in the opening balance sheet of the emerging entity, including tables, if appropriate.

- The basis for each adjustment presented in the fresh-start table, including the entries reflecting the discharge of debt obligations, issuance of any common and preferred stock as part of the reorganization, and any other adjustments or transactions resulting from the reorganization and application of fresh-start reporting. For fresh-start adjustments to assets and liabilities, the methods and assumptions used to develop fair value should be provided.

- A description of how any gains or losses related to the reorganization and the adoption of fresh-start reporting were calculated

- A description of how the amount of “excess reorganization value” or goodwill was calculated or determined

- If the reporting entity emerges from bankruptcy and uses a convenience date to record the adoption of fresh-start reporting, disclosure of this fact and the relationship to the actual effective date of the confirmation becoming effective. It should be noted that financial results in the period between the actual date and the convenience date are immaterial (if they are not immaterial, the reporting entity should consider if the use of the convenience date is appropriate).

- If a reporting entity emerges from bankruptcy and qualifies for fresh-start reporting as a new reporting entity for financial reporting purposes (see BLG 4.1), a vertical black line is required to be presented in the financial statements separating the predecessor reporting entity from the successor reporting entity, highlighting the change in basis between the reporting entities. In the basis of presentation footnote disclosure, we believe a clear distinction should be made to denote that the predecessor company and the successor company are separate reporting entities and as such are not comparable. The reporting entity should consider disclosure that discusses any changes in accounting policies or principles, including the adoption of new accounting standards by the successor company. Reporting entities qualifying for fresh-start reporting that emerge during an interim period should consider including a complete description of the successor
entity’s accounting policies as these are the initial financial statements of the successor entity. See FSP 17.6.5 for an illustrative example of blackline financial statements.

In addition to the disclosures above, when preparing the disclosures required under ASC 852-10-50-7, a reporting entity should consider the following:

**ASC 852-10-50-7**

Paragraph 852-10-45-21 requires additional information to be disclosed in the notes to the initial fresh-start financial statements when fresh-start reporting is adopted. That additional information consists of the following:

a. Adjustments to the historical amounts of individual assets and liabilities
b. The amount of debt forgiveness
c. Significant matters relating to the determination of reorganization value, including all of the following:
   1. The method or methods used to determine reorganization value and factors such as discount rates, tax rates, the number of years for which cash flows are projected, and the method of determining terminal value
   2. Sensitive assumptions – that is, assumptions about which there is a reasonable possibility of the occurrence of a variation that would have significantly affected measurement of reorganization value
   3. Assumptions about anticipated conditions that are expected to be different from current conditions, unless otherwise apparent.

When determining reorganization value, Reporting entities may also consider disclosing the following:

- Values established by the Court, including any ranges of values considered and the point within the range that was selected
- A description of how the enterprise value is used to derive the reorganization value (see discussion of reorganization value in BLG 4.3.1)

Reporting entities should also consider the fair value disclosures required by ASC 820, *Fair Value Measurements*.

### 7.5 Liquidation basis disclosures

In the period in which a reporting entity adopts the liquidation basis of accounting, it should consider the following disclosures described in ASC 205-30-50:

- An indication that the financial statements are prepared using the liquidation basis of accounting, including the facts and circumstances surrounding the adoption of the liquidation basis and a description of how the reporting entity determined that its liquidation was imminent.
- A description of the reporting entity's plan for liquidation, including a description of the manner in which it expects to dispose of its assets and settle its liabilities, and the expected date by which it expects to complete its liquidation.
The methods and significant assumptions used to measure its assets and liabilities, including any changes to such methods and assumptions.

If applicable, the type and amount of costs and income in the statement of net assets in liquidation and the period over which those costs are expected to be paid or income earned.

In addition to these required disclosures, a reporting entity which has adopted the liquidation basis of accounting should continue to make all other disclosures required by other GAAP that are relevant to its financial statements.

Since the liquidation basis of accounting represents generally accepted accounting principles for entities in liquidation, it is inappropriate to refer to the adoption of the liquidation basis as a change “from generally accepted accounting principles to the liquidation basis of accounting.” It is, however, appropriate to highlight in the notes to the financial statements that the basis of preparation has changed from going concern basis to the liquidation basis of accounting.

### 7.6 SEC reporting considerations (during bankruptcy)

A reporting entity that is an SEC registrant should consider the following unique reporting considerations:

- Notification of a bankruptcy filing (see BLG 7.6.1)
- Confirmation of a plan of reorganization (see BLG 7.6.2)
- Pro forma financial information (see BLG 7.6.3)

#### 7.6.1 Notification of a bankruptcy filing

When a reporting entity initiates a proceeding under the Bankruptcy Code or in any other proceeding under state or federal law in which a court or governmental authority has assumed jurisdiction over substantially all of the assets or business of a registrant or its parent, the reporting entity is required to file Form 8-K under Item 1.03 within four business days. The Form 8-K should include:

- The name or other identification of the proceeding;
- The identity of the court or governmental authority;
- The date that the jurisdiction was assumed; and
- The identity of the receiver, fiscal agent or similar, and the date of their appointment.

A reporting entity should include, as an exhibit to its Form 10-K or Form 10-Q, its plan of reorganization or liquidation if such plan becomes effective during the reporting period.

#### 7.6.2 Confirmation of a plan of reorganization (bankruptcy)

A registrant is required to file Form 8-K under Item 1.03 within four business days of the approval of its plan of reorganization or liquidation by a court or governmental authority. The Form 8-K should disclose:
Common disclosures for entities in bankruptcy or liquidation

- The identity of the court or governmental authority;
- The date that the order confirming the plan was entered into by the court or governmental authority;
- A summary of the material features of the plan and, pursuant to Item 9.01, a copy of the confirmed plan;
- The number of shares or other units of the registrant or its parent issued and outstanding, the number reserved for future issuance in respect of claims and interests filed and allowed under the plan, and the aggregate total of such numbers; and
- The assets and liabilities of the registrant or its parent as of the date that the order confirming the plan was entered, or a date as close thereto as practicable.

7.6.3 Pro forma financial information

A registrant may include pro forma financial information prepared in accordance with SEC Regulation S-X, Article 11, in an SEC registration statement, proxy statement, Form 8-K, or other document upon emergence from bankruptcy. The purpose of preparing the pro forma financial information is to provide users of the unaudited pro forma financial statements with material information and disclosure that give effect to the plan of reorganization and, if applicable, the application of fresh start reporting.

A registrant would follow Regulation S-X, Rule 11-02(a) which sets forth the general requirements for presentation of pro forma financial information including:

- An introductory paragraph which briefly describes the information specified in Regulation S-X, Rule 11-02(a)(2)
- Pro forma condensed balance sheet as of the end of the most recent period for which a consolidated balance sheet has been presented
- Pro forma condensed statement of comprehensive income presented for the most recently completed fiscal year and subsequent interim period up to the most recent interim date for which a balance sheet is required
- Explanatory footnotes